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THE FEDERAL INCOME TAX

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# THE FEDERAL INCOME TAX

BY

ROBERT MURRAY HAIG, THOMAS S. ADAMS, THOMAS REED POWELL, FRED T. FIELD, ROBERT H. MONTGOMERY, GEORGE E. HOLMES, ARTHUR A. BALLANTINE, WALTER A. STAUB, R. V. NORRIS, AND P. S. TALBERT

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EDITED BY

ROBERT MURRAY HAIG, PH.D.
*Associate Professor, School of Business,*
*Columbia University*

WITH AN INTRODUCTION BY

EDWIN R. A. SELIGMAN, PH.D., LL.D.
*McVickar Professor of Political Economy*
*Columbia University*

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# INTRODUCTION

## THE PROBLEM IN GENERAL

BY

EDWIN R. A. SELIGMAN, Ph.D, LL.D.

The taxation of income is a relatively new phenomenon in American fiscal life. Only within a decade has the Federal Constitution been amended so as to make a national income tax possible; and this amendment came in the nick of time. It is appalling to think of the situation into which we should have been plunged had we not been in a position to aliment our revenues during the Great War from this source. The very newness, combined with the hugeness, of this fresh device has, however, naturally engendered all sorts of difficulties from which we are slowly trying to extricate ourselves.

In every new fiscal project there are three stages which must be traversed. The first is for the legislator to decide as to the fundamental principles on which the bill is to be constructed. These principles are primarily economic in character. Inasmuch as fiscal science is still a youthful discipline in America and in view of the comparative insignificance of the income tax in the public finance of foreign countries, the economists have not yet addressed themselves, with complete success in achieving unanimity of results, to many of the problems which must guide the legislator. Some of these questions have indeed received a fairly careful study, such as that of exemptions and abatements for the minimum income, the justification of progressive taxation, and the position that ought to be occupied by an income tax in the general fiscal scheme. But other and equally fundamental problems still await a searching examination at the hands of economists and students of public finance.

At the very outset we are confronted by the question of

what income really means. To this many answers have been given. But no thoroughgoing fiscal analysis of the conception has yet been made, and as a consequence no two countries agree in the law on the subject. Among the fundamental points at issue here are questions like the following:

Is income to be conceived of in terms of money, of money's worth, or of mere psychic benefit? If income is a flow and capital a fund of wealth, between what periods of time is the flow realized, and when does the flow congeal into a fund? Are both realization and separation necessary to the concept of income? Does income include the appreciation of capital? Are gifts to be considered income? The decision as to these and many other similar questions waits upon a far more thorough analysis than is found in the ordinary books.

After this basic question is settled other difficult problems present themselves. The general rate of taxation is indeed primarily a political question and, as such, one for the statesmen to ponder and decide. But the question of the effects of a drastic progression and of the influence of high surtaxes involves an economic analysis. Again, while there is substantial unanimity among students of public finance as to the desirability of differentiating incomes according to the sources from which they are derived, there is great diversity of opinion as to the more recent proposition of differentiating incomes according to the purpose to which they are to be devoted. In other words, while the distinction between earned and unearned income is generally accepted, this is far from being the case as to the distinction between income saved and income spent.

A similar lack of unanimity is manifest in the treatment of losses, as contrasted with gains, in the problem of wasting assets, and in the domain, so important in modern industrial society, of business reorganizations. On every side, in fact, we are confronted with problems bristling with difficulties, into which the economist has thus far put scarcely more than an entering wedge and without a successful treatment of which the legislator must necessarily flounder. It is the purpose of these addresses to attempt a beginning at least in the contribution to a more thoroughgoing economic analysis. Until fis-

cal science reaches a definite conclusion on these problems the way of the legislator will be a thorny one.

In the second place, it is to be noted that even though the fundamental economic and fiscal principles have been settled, the legal and constitutional aspects of an income tax law, as indeed of all laws, is of commanding importance. So far as the mere framing of the language is concerned, the matter can well be left to the bureaus of legislative drafting and to the competent official advisers of the legislature. However, when we leave the field of phraseology, important though that be, and enter upon that of legal and constitutional validity, we again encounter many difficulties. Here we have to deal not only with the precise legal effect of the various provisions of the act but with their constitutional aspects. It is questionable whether the legitimate desire to give a fixed constitutional interpretation of a complicated statute like the income tax law is not resulting in a regrettable tying of the hands of the legislator and an undue curtailment of legislative discretion, with the result of raising many new problems in the place of the single problem which the courts endeavor to settle. We are already now beginning to suffer from a complexity which is more or less foreign to the system in England or other countries. Inasmuch as certainty is one of the prime requisites of a good tax system, the attempt of our courts to achieve certainty and to make it harmonize with constitutionality is one of supreme interest. Several of the addresses in this course, accordingly, are devoted to problems of constitutionality and of legal interpretation.

The adoption by the legislator of definite economic principles and the enactment of these principles into a well-phrased, well-considered, and constitutionally valid enactment constitute only a part and perhaps even the minor part of the matter. Since a law has to be executed, the administrative aspect of an income tax is perhaps the most significant of all. It is precisely here that the chief difficulties are encountered. For it is proverbial that democracies are for obvious reasons relatively weak in the administration of laws. This is especially true in the case of the income tax. The novelty and the immensity of

the system have put upon our administration a responsibility under which it is staggering and groaning. The difficulty in the problems of administrative interpretation of the income tax is evidenced by the flood of administrative regulations which have been issued during recent years.

There are two points apart from the results of general political considerations which distinguish the American from the British income tax administration. In the first place, a broader discrimination is vested by the British law in the administrative authorities than is the case in the United States. This lack of administrative discretion and the virtual tying of the hands of the administrator are responsible for not a little of our existing embarrassment. On the other hand, however, the attitude of the official toward the taxpayer is different in the two countries, perhaps in part as a result of the above situation. Whereas the British administrator seeks primarily to do even-handed justice, as between the individual and the government, the American administrator has as his paramount aim the interests of the Treasury. In the one case we have a more or less successful accommodation with the particular taxpayer; in the other case we have, frequently, a more rigid and inelastic interpretation of the law. The problems of dealing with the individual taxpayer, of the relief provisions, of the Treasury procedure in particular cases, of the treatment of inventories, of consolidated returns and the like—all these involve administrative problems of the greatest difficulty and complexity. Not a few of the addresses of this course deal with such problems.

The gentlemen who were invited to prepare the following contributions are each of them acknowledged authorities in their respective fields. Economists, accountants, lawyers, and administrators—they form a group the coöperation of which is indispensable in any attempt to make the American income tax worthy of the paramount rôle which it is destined to play in our fiscal system for many a long year. These addresses constitute, as a whole, the most signal attempt that has yet been made in any country to elucidate the basic principles of importance to the framer, the administrator, and the payer of the modern income tax.

## EDITOR'S NOTE

The papers printed in this volume were read at Columbia University in December, 1920, as a special course on income tax problems offered under the auspices of the School of Business. The keen interest shown in the lectures at the time of their presentation indicated the desirability of publishing them in a form which would render them available for general circulation.

In preparing the manuscripts for the press, the editor has in the main restricted his changes to those which were necessary to bring practice into uniformity with respect to typography, form of references, etc. Because of the brief time which was available for editing, a full checking of references to authorities was not possible and responsibility for their accuracy rests with the individual authors. It is also perhaps unnecessary to add that neither the University nor the editor assumes responsibility for expressions of opinion appearing in the papers. No attempt, of course, has been made to eliminate conflicts of opinion, of which there are several instances. Care is taken to call attention to such conflicts.

The form of the references calls for an explanatory statement. The Revenue Act of 1918 is ordinarily referred to as the "1918 law" and its predecessors as the "1909 law," "1913 law," "1916 law" and "1917 law." A reference to a section without other specific citation is a reference to the 1918 law. Treasury Decision is contracted to T. D. Citations in the text to articles without other designation may be assumed to have reference to the articles of *Regulations 45*, the general Treasury interpretation of the 1918 law. In addition to the decisions and regulations, the Treasury now publishes its more formal rulings in a *Bulletin* whose issues are numbered consecutively by years, No. 47–20, indicating that the number is the 47th issued and that it appeared in 1920. The contents of the bulletins are consolidated in the *Digest of Income*

*Tax Rulings*, which appears from time to time. The following abbreviations are used in the *Digest* and the *Bulletin:*

Op. A. G.—Opinion of Attorney General.
O. or L. O.—Solicitor's law opinion.
Sol. Op.—Solicitor's opinion.
S.—Solicitor's memorandum.
T. B. R.—Advisory Tax Board recommendation.
T. B. M.—Advisory Tax Board memorandum.
A. R. R.—Committee on Appeals and Review recommendation.
A. R. M.—Committee on Appeals and Review memorandum.
O. D.—Office decision.

The Income Tax Service of the Corporation Trust Company is referred to as I. T. S.

In conclusion the editor, both personally and on behalf of the University, desires to thank those who, as authors of papers and as subscribers to the course, contributed to the successful culmination of the plan for the special course and the publication of this book.

ROBERT MURRAY HAIG

School of Business
Columbia University in the
City of New York
January 3, 1921

# THE CONCEPT OF INCOME—ECONOMIC AND LEGAL ASPECTS

BY

Robert Murray Haig, Ph.D.

The Sixteenth Amendment to the Constitution gives Congress power to tax "incomes, from whatever source derived." Acting under this grant of authority, Congress has, for eight years past, collected taxes upon what it has been pleased to term income. In no one of the three statutes passed during that time has Congress attempted to formulate definitely a positive definition of income. Moreover, eight years have proved insufficient to secure from the courts a fully adjudicated definition. It is true that certain important items, notably stock dividends, which Congress has sought to include within the scope of the term, have been eliminated by court decisions. Much more important items, however, await judicial consideration. Even such questions as the taxability of gains from appreciations of property values are still unsettled. Such decisions as have been handed down appear to be leading toward a definition of income so narrow and artificial as to bring about results which from the economic point of view are certainly eccentric and in certain cases little less than absurd. The unsettled status of the definition and the wide differences of opinion which exist as to what the term *income*, as used in the Sixteenth Amendment, did, does, or ought to mean justifies an examination of its content from the point of view of the economics of the problem and from the point of view of the practice elsewhere.

In this paper no attempt is made to evaluate or criticise the interpretation of the statutes or the Sixteenth Amendment by the courts from the point of view of general legal and constitutional principles involved. This will be done in

other papers to follow. The approach here taken is the broader one of fundamental economics and equity.

First of all, consider what the economist means when he speaks of income. In this case, as in so many others, the economist uses a term in approximately the same sense as it is used in ordinary intercourse. It has merely been necessary for him to be more precise as to exact limits and distinctions. There has been no revolutionary contribution to economic thought on this topic since the passage of the Sixteenth Amendment. The economist and the man in the street both use the term now as they used it in 1913.

Modern economic analysis recognizes that fundamentally income is a flow of satisfactions, of intangible psychological experiences. If one receives a dollar he receives something which he ordinarily can and does spend—perhaps for a dinner. Is his income the dollar, or is it the dinner which he buys with the dollar, or is it, at bottom, the satisfaction of his wants which he derives from eating the dinner—the comfort and the sustenance it yields to him? If one spends his dollar for something more durable than a dinner—say a book or a pipe—is his true income the book or the pipe, or the series of satisfactions or "usances" arising from reading the book or smoking the pipe? There is no doubt as to the answer to these questions. A man strives for the satisfaction of his wants and desires and not for objects for their own sake.

How universal is the acceptance of this general view may be gauged from the following pronouncements of the writers of some of the most recent and widely used texts dealing with the principles of economics. Thus Professor Taussig, of Harvard, disposes of the question:

> Now just as all production in the last analysis consists in the creation of utilities, so all income consists in the utilities or satisfactions created. Economic goods are not ends in themselves but means to the end of satisfying wants. . . . Our food, clothing, furniture, may be said to yield psychic income. They shed utilities, so to speak, as long as they last.

Professor Irving Fisher, of Yale, in his book asserts most categorically that "Income consists of benefits," and, again,

[1] *Principles of Economics*, 1916, vol. I, p. 134.

that "A flow of benefits during a period of time is called income." [2]

Professor Ely, of Wisconsin, emphasizes the same point in these words:

> Wealth refers to the stock of goods on hand at a particular time. Real income, on the other hand, has reference to the satisfaction we derive from the use of material things or personal services during a period of time.[3]

Finally, Professor Seligman, in his *Principles of Economics*,[4] declares that "We desire things at bottom because of their utility. They can impart this utility only in the shape of a succession of pleasurable sensations. These sensations are our true income."

The testimony of our leading economists on this point is unanimous. Even in England, where the concept of taxable income is different from our own in important respects, the modern economists recognize the validity of the analysis set forth above. Thus Professor Alfred Marshall, of Cambridge, states that:

> . . . a woman who makes her own clothes, or a man who digs in his own garden or repairs his own house, is earning income just as would the dressmaker, gardener, or carpenter who might be hired to do the work. . . For scientific purposes, it would be best if the word income when occuring alone should always mean total real income.[5]

However, the economist, while recognizing all this, realizes that before he can proceed far with his analysis of economic phenomena he must arrive at something more definite and more homogeneous—less diaphanous and elusive than these psychic satisfactions. An individual, it is true, can compare the relative worth to him of a pipe or a book or a dinner and arrange his order of consumption without the use of any formal common denominator such as money. Yet this individual would have great difficulty in telling you exactly how much satisfaction he derived from his pipe or his book. How much more difficult would it be for a second person to measure those

[2] *Elementary Principles of Economics*, 1911, p. 34.

[3] *Outlines of Economics*, 1908, p. 98.

[4] 1914, p. 16.

[5] *Economics of Industry*, 1901, p. 51.

satisfactions for him without the aid of some common unit! How impossible it is to compare one man's satisfaction with a book with another man's satisfaction with his dinner! Thus Professor Taussig is led to conclude that:

> . . . for almost all purposes of economic study, it is best to content ourselves with a statement, and an attempt at measurement, in terms not of utility but of money income. . . The reason for this rejection of a principle which is in itself sound lies in the conclusion . . . regarding total utility and consumer's surplus: They cannot be measured.[6]

The basis of comparison, the foundation upon which economic interaction and exchange take place is, of course, that of the common, universally-acceptable unit of value—money. The usances and satisfactions and the goods and services supplying them which are of significance to the economist in his analysis are those which are susceptible of evaluation in terms of money. This, of course, involves the element of scarcity, relative to demand. When one can express his wants and satisfaction in terms of dollars and cents he can use a language which other men can understand and which means something to the economic community generally.

It should be carefully noted, however, that, first, when one abandons "usances" and satisfactions and substitutes the goods and services yielding these satisfactions, he is taking a step away from the fundamentals, for two equal sets of goods and services may yield very different satisfactions; and second, if one takes the next step, as most income tax laws do in the main, and substitutes money received during a period in place of goods and services used, as the content of the term income, he has really moved a very appreciable distance from the fundamental conception, for not only does everyone receive goods and services of greater or less amount without buying them with money, but also everyone is, in effect, considered to be in receipt of his income when he gets the money with which to buy the goods and services which will yield the usances and satisfactions which go to make up his true income. Indeed, the purchase of the goods and ser-

[6] Taussig, *loc. cit.*

vices may, of course, be postponed indefinitely. In the words of Professor Ely:

> Money income should, perhaps, refer to the value of the goods consumed and the services enjoyed, although in popular speech and by many economists the word is used in the literal sense of the net amount of money that comes in, whether it is spent for enjoyable things or is saved.[7]

It is apparent from what has been said that when taxable income is identified with money received in a given period two approximations have been introduced, each of which involves anomalies and inequalities as between members of the same class ostensibly on equal terms. For example, two persons who receive precisely equal amounts of goods and services may derive therefrom very unequal "usances" and satisfactions. If "usances" and satisfactions are really the proper theoretical basis for apportioning the tax burden there is here an inequality. Certainly, everyone will agree that they constitute an entirely impracticable basis. Consequently, any theoretical injustice involved must necessarily be incurred if we are to have an income tax at all. But is there, after all, any theoretical injustice? Who, for instance, would seriously defend the proposition that taxes should be apportioned according to capacity for appreciation rather than according to the capacity to command the goods and services which are appreciated? The only economically significant goods are those which are susceptible of evaluation in terms of money.

In the next place, two persons who receive precisely equal amounts of money-income may receive very unequal amounts of goods and services, either because one has postponed spending a larger portion of his money than the other, or because one has received more income *in kind.* No great harm is done if the person who postpones spending his money is taxed upon it when he receives it rather than when he spends it. However, it is a different matter in the case of income *in kind*, such as the fire-wood the farmer cuts from his wood lot or the vegetables for his table which he gathers from his garden. Certainly, the fact that one man buys his fire-wood or

[7] Ely, *loc. cit.*

his vegetables, rather than receives them without the formality of a money sale, should not operate so as to increase the weight of his income tax. The economics of this situation is very clear. The statement made in the preceding paragraph is that the goods and services which are of significance are those which are susceptible of evaluation in terms of money. It is not necessary that they should actually have passed through the process of a sale. From the point of view of equity it is theoretically important that all goods [8] and services received without payment should be accounted for in case it is possible to value them in terms of money.

Perhaps it is clear, then, how and why the fundamental economic conception of income as a flow of satisfactions must undergo substantial modification to fit it for use in economic analysis generally and for use particularly as a basis for apportioning a tax burden. The satisfactions themselves become economically significant for the purpose only when they are susceptible of evaluation in terms of money. It is necessary as a practical proposition to disregard the intangible psychological factors and have regard either for the money-worth of the goods and services utilized during a given period or for the money itself received during the period supplemented by the money-worth of such goods and services as are received directly without a money transaction.

If the first option is taken, *viz.*, the money-worth of the goods and services utilized during a given period, we arrive at a pure consumption tax, unless indeed we attempt an evaluation of the satisfactions arising from the consciousness of a saved surplus which is obviously an impracticable procedure. It is interesting to recall that this is the result which the English economist, John Stuart Mill, sought to establish a half-century ago, although the analysis underlying his conclusions was a quite different one. To tax saved income and then in future years to tax the income from those savings was, he contended, double taxation.[9] The same conclusion has

[8] For gifts, *cf. infra.*, p. 26.

[9] The source of this and several other statements made in this paper with respect to the theories of foreign economists is an unpublished monograph by Mr. Clarence Heer, a former student in the seminar of Professor Seligman.

been reached by certain Italian writers, notably Einaudi.[10]

The second option, however, has been the one generally adopted as the definition of income in modern income tax acts. Under this conception, income becomes the increase or accretion in one's power to satisfy his wants in a given period in so far as that power consists of (*a*) money itself, or, (*b*) anything susceptible of valuation in terms of money. More simply stated, the definition of income which the economist offers is this: Income is the *money value of the net accretion to one's economic power between two points of time.*

It will be observed that this definition departs in only one important respect from the fundamental economic conception of income as a flow of satisfactions. It defines income in terms of power to satisfy economic wants rather than in terms of the satisfactions themselves. It has the effect of taxing the recipient of income when he receives the power to attain satisfactions rather than when he elects to exercise that power. This should do no violence to our sense of equity, however. The fact that a man chooses to postpone the gratification of his desires is no sufficient reason for postponing his tax.

It will be readily agreed that this definition, *viz.*, that income is the net accretion to one's economic strength in a given period, constitutes, then, the closest practicable approximation of true income. It coincides very closely indeed with the flow of economic "usances" and satisfactions expressed in terms of money, which all economists agree constitutes the thing after all we are attempting to measure. Certainly this definition is scientific in the sense that it is broad enough to include everything of like nature. Anomalies are avoided by the very simple expedient of casting the definition in broad terms. On the other hand, is the definition so broad that it includes items fundamentally dissimilar? The test of similarity applied is power in terms of money to command goods and services yielding usances and satisfactions. Is it possible to add any other test without so restricting the definition as to exclude items which should be included and thus introduce

[10] Luigi Einaudi, *Corso di Scienza della Finanza*, 3rd Edition, Capitalo 4.

inequities and discriminations as between persons in substantially identical economic positions? Professor Seligman believes that in addition to the criteria of money-value, periodicity, and realization included in the definition as stated above, there should also be applied the test of separation as a necessary attribute of income.[11] Much depends upon precisely what is meant by separation. Included in the test of "susceptibility of evaluation" is certainly the condition that the valuation attached to the accretion must be sufficiently definite to form the basis for a realization. The item must be realizable and separable, certainly. That there must be an actual physical separation, however, before economic income is realized, cannot, I believe, be conceded, for, with a definition so narrowed it is not possible, in the stock-dividend case, for example, to remove the inequity as between different classes of security holders. The adoption of the definition as developed above leads to the same conclusion as that reached by Professor Seligman, *viz.*, that stock-dividends are not income, but the reason is not that the income has not yet accrued to the shareholder when the stock-dividend is declared, but rather that, economically, it has accrued to the shareholder even before the stock-dividend was declared, *viz.*, if and when the improved economic position of the corporation was reflected in the holdings of the stockholder with sufficient definiteness to be susceptible of evaluation.

What more narrow definition than the one suggested will solve the problems presented by the following three questions?

1. Are stock-dividends income?
2. Is undistributed surplus income to the shareholder?
3. Are appreciations in property values income?

1. *Are stock-dividends income?* The Supreme Court has decided that stock-dividends are not income.[12] What is the effect of this decision upon the economic position of the three following persons, *A*, *B*, and *C*, who are shareholders in similar corporations, each owning ten per cent. of the stock? Assume

[11] Edwin R. A. Seligman, "Are Stock Dividends Income?" *American Economic Review* September, 1919.

[12] Towne *v.* Eisner, 245 U. S. 418; Eisner *v.* Macomber, 252 U. S. 189.

that each company makes $1,000,000 in the given accounting period. On the day of the directors' meeting when the question of the declaration of a dividend will be considered, the economic position of all three men is the same, and no one would deny that the economic strength of each had been increased by virtue of his ten per cent. interest in a corporation which has earned a million dollars net income. *A's* corporation declares a cash dividend of $1,000,000, *A's* share being $100,000 in money. *B's* corporation declares a stock-dividend of $1,000,000, *B's* share being $100,000 in stock. *C's* corporation declares no dividend, *C's* interest in the earnings of that year being reflected presumably in an increase in the market value of his stock. Before the stock dividend decision *A's* share and *B's* share were both considered taxable income. *C* was taxed only if and when the profits were distributed—unless in truth he were taxed indirectly in case he sold his stock at an appreciated value. *A* and *B* were together in one class. *C* was alone in a second class. As between the two classes there was a marked difference of treatment. The stock dividend decision disassociated *B* from *A* and placed him in the class with *C*. The line marking the difference of treatment is now no longer drawn between *B* and *C*. It is drawn between *A* and *B*. But the point is that the difference persists. Can justice be established in an income tax as among *A*, *B*, and *C* by any action short of making each of them subject to income tax upon the increase in his economic strength resulting from the earnings of the corporation in which he is interested? In this case *A* should account for the $100,000 cash dividend in his income tax return. *B* should account for the market value of his stock dividend on the last day of the year, minus any decline, if any, in the market value of his original block of stock during the year. *C* should be taxed on the increased market value of his block of stock. All of them, under the assumption, have received a net accretion of economic strength during the year definite enough to be susceptible of evaluation. Can a more narrow concept of income than this solve the problem here presented?

2. *Is undistributed surplus income to the shareholder?* The problem with respect to the taxation of undivided surplus may be presented best by a similar example. Assume that *A* owns ten per cent. of the stock of a corporation and that *B* owns a ten per cent. interest in a partnership, each of which earns $1,000,000 during a given accounting period. *B* must include in his individual income tax return his distributive share of the profits, $100,000, which item becomes subject to both normal and surtax rates. On the other hand, *A* includes in his personal income tax return his share of the profits in his corporation only if and when these profits are declared as dividends. If they are never distributed, they never become subject to the individual surtax rates. The corporation, it is true, pays the so-called normal tax at the time when the profits are earned, and *A* may take credit for part of this normal tax in his individual return when he receives the dividend. It is also true that the excess profits tax applies to corporate profits and not to partnership or individual profits and that for the present this has brought about a condition of poise which will be sadly disturbed if the excess profits tax should disappear. But what precise solution is there for this badly muddled situation short of the adoption of a concept of income broad enough to tax *A* on the increased market value of his stock which presumably results from ploughing the earnings back into the business of the corporation? In the absence of dependable market quotations, would not the accounts of the corporation, as to undistributed surplus, furnish light as to the increase in *A's* economic position?

3. *Are appreciations in property values income?* At the present time we consider appreciations of property values taxable income.[13] But we inventory nothing except stock-in-trade. In other words, we say in effect that nothing appreciates in value until it is sold. This, of course, is not in accord

[13] In a decision published after this paper was written, Judge J. D. Thomas, of the District Court of the United States, District of Connecticut, has decided, in the case of Brewster *v.* Walsh, Collector (No. 2133 at law), that the increase in the value of capital assets when realized by sale or other disposition, by one not a trader or dealer therein, is not income, and hence is not taxable as such. The Government has announced an appeal to the Supreme Court.

with economic facts, however perfectly it may synchronize with accounting practice. The truth is that certain so-called accounting principles have been evolved with other ends primarily in view than the accurate determination of relative taxpaying ability. The general result may be illustrated as follows: *A* and *B* each buy houses in 1914 for $10,000. Both houses appreciate in value until they are worth $20,000 each in 1916. *A* sells his house in 1916 and becomes taxable on the $10,000 profit. The highest surtax rates in 1916 were thirteen per cent. He holds his $10,000 uninvested. *B* retains his house, but after 1916 the value remains stationary. He sells in 1920 and realizes $10,000 profit. In 1920 the rates range as high as seventy-three per cent. Here are two men whose economic strength has varied in precisely the same manner. They are called upon to pay quite different amounts in federal income taxes. Can any proposal offer a satisfactory solution of this problem which does not assume a concept of income similar to that outlined above? To achieve exact justice the increased economic strength of the two men must be measured *period for period.*

The general conclusion from the foregoing discussion is this: That the economist when asked whether a particular item is income or is not income, must, in the opinion of the writer, make his reply depend upon whether the receipt of that item has increased the economic power of the recipient to command satisfaction-yielding goods or services. If it does, it is income; if it does not, it is not income. The answer would then be based on practically the bed-rock of economic principle—not quite, perhaps, because of the approximations already pointed out, but certainly on a level as near as is practicable to that bed-rock. If courts are to base their decisions on economic principle, the answer to their queries should be in terms of the most fundamental of principles.

These statements present nothing which is really novel. This same doctrine has long been taught by that faithful hand-servant of the practical business man—the accountant. When one examines the standard books dealing with the theory of accounting he finds the definition of the net profit

of a business undertaking stated in almost the precise words used in the general definition given above. Thus, A. Lowes Dickinson in his *Accounting Practice and Procedure* [14] says:

> In the widest possible view, profits may be stated as the realized increment in the value of the whole amount invested in an undertaking; and, conversely, loss is the realized decrement.

Again, Robert H. Montgomery in his *Auditing* remarks:

> If an absolutely accurate balance sheet could be prepared at the beginning and the end of a period, the difference would constitute the net profit or the net loss for the term.

The economist and the accountant are also, of course, in complete accord as to the theoretical distinction between income on the one hand and capital, or property, or wealth on the other. The accountant's "absolutely accurate balance sheet," to use Montgomery's phrase,[15] is synonymous with the economist's "fund relating to a given instant," [16] to use Professor Fisher's language, or, "accumulation of . . . utilities or income at an instant of time," [17] to use Professor Seligman's expression. The establishment of "net income," both agree, must not involve an impairment of the capital sum.

Confusion of thought is sometimes caused by the fact that the accountant usually speaks in terms of a business enterprise as a separate entity, while the economist usually speaks in terms of the individual person. The distinction between gross and net income—which occupies so large a part of the attention of the accountant—is summarily dismissed by the economist whose typical income receiver is the man whose expenditures are predominantly for purposes of personal consumption. The definitions and reasoning of the accountant, however, are very readily fitted to the case of this typical economic man if the accounting period is reduced to its true economic length, which in the case of the wage earner is a week and the salaried worker a month. In the typical business the period is, of course, a year, the net income not being determined and distributed until the end of that period.

[14] p. 67.
[15] 1916, p. 206.
[16] Fisher, *op. cit.*, pp. 56–57.
[17] Seligman, *loc. cit.*

The detailed technique of determining the precise deductions which should properly be made as business expenses, as contrasted with expenditures of a capital nature, has been developed by the accountants along lines entirely acceptable to the economist. Many interesting theoretical questions are involved, such, for example, as the degree to which risk may properly be insured against by means of various reserves, but a survey of this portion of the field—while germane to the topic—cannot be developed in the time available. Ordinarily the economist contents himself with the assertion that the income must be *net*, that all expenses connected with its production must have been met.

The problem of distinguishing sharply between business expense and personal expense is one which is the occasion of much practical difficulty and upon which wide differences of opinion exist. Certain German writers, *e.g.*, Weissenborn,[18] go so far as to classify all personal and family expenditures for food, clothing, and shelter as deductible expenses, rendering the income tax substantially a tax on merely saved income. This is a result diametrically opposite to that reached by the English and Italian economists referred to above[19]—and it is a conception which does not find any considerable response except in so far as the relief of a bare minimum of subsistence, under the various personal exemptions, may be conceived to be such a response.

It is often a long step, however, between the accountant's theory and his practice; between his abstract statement as to what net profit is and the actual figure certified as such on a balance sheet. It is an equally long step for the economist between his general definition of income and the content of the category which in his opinion forms the best basis for the imposition of an income tax. This is a practical, workaday world full of imperfections. Most economists, popular superstition to the contrary, are fairly conversant with the facts of modern business life and are fairly well aware of the practical difficulties of fitting abstract conceptions to the

[18] *Die Besteuerung nach dem Ueberfluss*, 1911.
[19] *Cf. supra*, pp. 6-7.

environment of the market-place. Certainly modifications—serious modifications—must be made in the general definition of income, as formulated above, to fit it for use as the item of net income entered on Form 1040 or Form 1120, and the scientific economist in advising the legislator would be the last to suggest an attempt to follow the implications of his analysis without regard to the limitations imposed by the actual conditions under which the law must function. Such a course would be anything but scientific. The point to be grasped very clearly, however, is this: Those modifications to which he would consent and which, indeed, he is among the first to urge, are, after all is said and done, merely modifications—merely concessions made to the exigencies of a given situation. For example, one might urge that no tax be placed on a gain arising from the appreciation of a fixed asset until it is actually sold. But the recommendation should not be urged on the ground that the appreciation is not income until it is sold. The economic fact is that the owner of that asset comes into possession of economic income whenever the increase in the value of that asset is sufficient in amount and definite enough in character to be susceptible of precise evaluation in terms of money. Again, one might urge that no tax be placed on the services which one actually enjoys when he lives in his own home rather than a rented one. But, again, that recommendation should not be supported by the assertion that this item is not income. It is income whenever it is susceptible of evaluation in terms of money. Neither the economist nor the courts should express their opinions in the form of an assertion that it is not income. That, it seems to the writer, is not the real question in either of the illustrations given. The real question is, rather: Is it justifiable to treat this item of income in some special way as compared with other items of income because of special circumstances surrounding its receipt? Thus, it may be futile and silly, from an administrative point of view, to attempt to include in the income tax return a money estimate of the income which the man receives when he lives in his own house. The Wisconsin authorities, after attempting to list such income for several

years, have decided that the game is not worth the candle. Or, it may be impracticable as an accounting proposition, to reflect the varying worth of capital assets on the balance sheet. As the accountant, Dickinson, points out:

> Inasmuch . . . as the ultimate realization of the original investment is from the nature of things deferred for a long period of years, during which partial realizations are continually taking place, it becomes necessary to fall back on estimates of value at certain definite periods, and to consider as profit and loss the estimated increase or decrease between any two such periods.[20]

If the difficulties of complete periodical revaluations are so great as to make it impracticable to tax appreciations as they accrue, they ought not to be so taxed, and the question is transformed into these new queries: "When may these appreciations best be taxed?" and "If they are taxed sporadically is the result so unjust that no attempt should be made to tax them at all?"

To the writer it seems unfortunate that the questions as to the constitutionality of the federal income tax on specific items are turning so largely on the question as to whether the items are or are not income. The items most controverted certainly fall within the definition of income established by the analysis of business facts made by both the economist and the accountant. Moreover, the concept of income is, after all, essentially an economic concept, and if the legal concept established by court interpretation under a particular constitutional provision or amendment departs in any very fundamental fashion from the economic concept, injustices may arise of such magnitude as to necessitate either the abandonment of the income tax or the adoption of a constitutional amendment which will give a positive and comprehensive definition of income. The difficulty could be avoided if the broad economic concept of income were frankly accepted with its single test as to whether the item resulted in an improvement in economic power capable of being evaluated. The questions which the courts would then be called upon to consider would be as to whether the modifications made by Congress and by the Treasury, in attempting to

[20] *Loc. cit.*

construct a concept of taxable income which will be at once workable and approximately just, are modifications which are reasonable and in conformity with the various constitutional guaranties.

It goes without saying that taxable income under an income tax law should approximate as nearly as practicable the true net income as defined by the analysis of the economist and the accountant. How close an approximation is possible depends upon the perfection of the environment in which the tax must live. No unnecessary departure from the true concept should be made. The imperfections of our present economic environment which are of most significance to this problem fall into three classes:

1. The imperfections of the economic standard of value;
2. The imperfections of accounting practice; and
3. The imperfections of the administration.

A perfect income tax is unattainable so long as modifications must be made because of imperfections in our standard of value, our accounting, and our administration. These classes will be taken up in turn.

1. *Imperfections of the economic standard of value.* That variations occur from time to time in the price level and in the value of money is well known to every person whose resources during recent years have been sufficiently limited to compel him to have any regard at all for his expenditures. If income is defined as the total accretion in one's economic strength between two points of time, as valued in terms of money, it is clear that his income will reflect every change in the value of money between those two points of time in so far as the items entered on the balance sheets at those times affect the computation. If the level of prices goes up ten per cent. the money value of my assets will ordinarily follow at a like rate. That particular increase in value does not really indicate an increase in my economic strength. My power to command economic goods and services has not increased, for the money-value of these goods and services has likewise increased. So long as we have a money standard which varies, we shall find that even a perfect accounting system will show a net income which is not

identical with the true accretion of economic power. Indeed, the more perfect the valuation and the accounting, the greater will this injustice be.

It must be borne in mind, however, that this is an evil which is with us under our present law. A man who sold an asset in 1920 which he had purchased in 1914, making an apparent profit of 100 per cent. and receiving his pay in fifty-cent dollars is, under our statute, subject to tax on his gain, although that gain is only apparent and not real. Moreover, the situation is particularly unjust under our present system. If complete periodical revaluations were used in determining income there would still be relative equality as between different taxpayers. But as the situation now stands, the transactions are closed in a haphazard and uneven fashion. A man who happens to sell out at the peak of the price curves, is taxed very unequally as compared with the man who continues his transaction until a period of lower price levels.

It should also be borne in mind that this element is of some influence even in an income tax such as that in force in Great Britain where appreciations in property values are not taxed, for an item of inventory included in one's accounts at the beginning of the year and sold in the course of the year will reflect the change in the prices during the period held.

If it were possible to modify the concept of taxable income so as to eliminate this variation it would certainly be desirable to do so. The prospect for a complete solution of the difficulty pointed out, however, is identical with the prospect for a perfect monetary standard. But an approximate solution might be realized if we were able to evolve a satisfactory index of the level of prices. If it were accurately known what the change in price level in a given year had been, it might be possible to qualify the results shown by a comparison of the balance sheets for the beginning and the end of the period in such a way as to eliminate the influence of the changing standard. But even this refinement is not likely to be introduced soon. Indeed, the desirability and urgency of its introduction is dependent largely upon the complete solution of the accounting problem, which solution is certainly not imminent.

2. *The imperfections of accounting practice.* The wide gap which stretches between theory and practice in the field of accounting has already been remarked. Until such time as everyone keeps accounts and the accounts furnish a perfect record of everyone's economic position, the concept of taxable income must be modified in order to meet the problem presented by the shortcomings of accounting practice. Dozens of illustrations of how the concept is modified in our statute because of the necessity of allowing for the imperfections and incompleteness of accounts will occur to everyone.

While the accounting ideal as stated by the leading theorists in the accounting field is in entire harmony with the economic analysis, it should be pointed out that many so-called accounting principles which are generally accepted are little more than rules of action formulated during an obsolete period when the use of accounts for tax purposes did not exist. So long as the chief purposes of the accounts were to provide a basis for applications for credit, and for the distribution of dividends, rules which tended toward a conservative statement of profits were certainly full of virtue. The increase in the tax burden has added a new primary use for the accounts, a use which demands certain qualities which are not important in the other cases. To form an entirely satisfactory basis for the imposition of income taxes the accounts must reflect the full, true, economic position of the taxpayer; and in so far as arbitrary rules of inventory valuations operate to build up hidden reserves, or other accounting practices tend to befog the picture, they must ultimately be eliminated and they have no place in truly scientific accounting.

3. *The imperfections of the administration.* A lively regard for the limitations of the administration is essential to the successful formulation of a tax statute. This is a factor which we have failed to recognize sufficiently in this country. Many of the modifications which our statute makes in the concept of income are obviously designed to simplify the problem of administration, but in spite of the number and character of these modifications there appears to be grave question as to whether they have been sufficient to reduce the administra-

tive task to manageable proportions. The British, with their splendid civil service, are appalled at the burden we place upon our inadequate treasury staff. Certainly such changes in the abstract definition of income as are necessary to make the statute practical and workable must be accepted, provided the cost in terms of equity is not so great as to make some available alternative tax a more attractive method of raising the revenue.

In addition to modifications on the above grounds, modifications of two additional types are often urged. Those who are convinced that taxation should be used for the furtherance of social ends often demand special modifications. For example, those who are deeply impressed with the desirability of increasing the amount of economic capital demand special treatment of the individual surplus of corporations, or reduced surtax rates upon that portion of individual incomes which are saved and reinvested. There are others who on social grounds believe in a differentiation between earned and unearned income.

Again, the fiscal necessities of the Government are sometimes urged as adequate ground for declining to bring the concept of taxable income into closer harmony with the concept of economic income, as in the case of the recent letter of the Secretary of the Treasury.

If time permitted it would be interesting to trace the historical evolution of the concept of economic income and of taxable income from the time these concepts became important down to the present. Only the barest summary, however, is here possible. The British income tax places very heavy stress upon the annual character of income. For an explanation of this conception, which results in the exclusion from taxable income of gains of an irregular nature, one must go back as far as the fifteenth century, when, with an agricultural society where few fortuitous gains developed, the idea of receipts as being annual in character became deeply impressed upon the minds of the people. It became the habit to think of one's regular receipts as his income, and to consider irregular receipts as additions to capital. Adam Smith spoke of income

both as what remains free after maintaining the capital and as what people can consume without encroaching upon their capital. Ricardo accepted Adam Smith's conception of economic capital but protested vigorously against a concept of taxable income which would include legacies and even wages. McCulloch developed a theory of differentiated income under which income from personal services was to be fully insured in order to put it on a fair basis as compared with the income from a building from which depreciation allowances had been subtracted. Despairing of the practicability of such a proposal, he concluded that income taxation was fundamentally unfair. John Stewart Mill disapproved of McCulloch's theory of differentiation, but insisted upon exemption for savings. Because of the practical difficulties in the way of this he urged a remission of an arbitrary percentage of the income from "temporary" sources.[21] This is essentially the plan which has been incorporated into the Italian income tax of today. As has been noted, Marshall defines income in the broadest possible fashion.[22]

Just as the British income tax has served as the model for the various continental income taxes, so English writers have influenced the thought of the writers in other countries. Thus the German writers since Schmoller have broken away from the concept of yield and have emphasized the subjective concept. These Germans all agree that income includes all goods which are placed at the disposal of the individual for the satisfaction of his wants, but they disagree considerably as to the exact composition of that income and its relationship to the concept of capital. The idea of the durability of the source plays a considerable rôle in their discussions. Schanz calls income the net inflow of means during a given period, including all usances and services having a money value.[23]

To Roscher, income is a rather restricted category consisting of the aggregate of goods which, arising within a given period of time as the yields of durable sources of revenue, are at the

[21] Heer, *op. cit.*
[22] *Cf. supra*, p. 3.
[23] Heer, *op. cit.*

disposal of the individual for the satisfaction of his personal wants and those of his family. Wagner and his associates, including Cohn, Newman, and Philippovitch, emphasize both periodicity and permanency of source. Income to them is either the sum total of goods which at regularly recurring intervals flow into the treasury of the individual, or those commodities, valuable services of third parties, and usances which, as periodic fruits of permanent productive sources, flow into the possession of the individual and over which he has absolute control.[24] It should be noted that here again appears the idea of separation emphasized by Professor Seligman.[25]

If this is what the foreign writers say about the economic concept of income, what do the foreign legislators do about establishing the limits of the concept of taxable income? Both the British and the German statutes construct a concept much more narrow than ours. Both attempt to differentiate between regular and fortuitous gains. A British salaried man who dabbles in the stock exchange is not called to account for his gains or losses. The owner of a residence in Germany is not asked to include a profit realized on its sale. Gains and losses on property are recognized only when they accrue with respect to the stock-in-trade of a dealer. In Great Britain, if one sells his mine at a profit, that profit is not subject to income tax, but neither are depletion allowances deductible in making one's annual returns. The consideration paid for a lease is not taxed, but depreciation in the lease may not be deducted. The British do not tax gains from appreciation in the value of real estate, which reduces considerably the significance of the late-lamented British Increment Value Duty. As a matter of fact, the effect of this Duty was to operate as a fairly reasonable income tax on the profits from such transactions.

Having formulated a definition of economic income, having presented the broad grounds upon which modifications may properly be made in order to fit the concept to the necessities of the business situation, and having made a very brief survey

[24] *Ibid.*

[25] *Cf. supra*, p. 8.

of foreign theory and practice, let us examine the meaning of the term income as used in the Revenue Act of 1918 to ascertain how closely it approaches the ideal conception of income. Such a discussion will bring clearly to the fore the implications of the proposed definition; it will test the adequacy of that definition to resolve the anomalies of our present practice; and will raise questions as to the desirability of changes in our present statutory concept.

The Revenue Act of 1918 states that "there shall be levied, collected, and paid for each taxable year upon the *net income* of every individual (and corporation) a tax." [26] Net income is defined as gross income minus certain specific deductions.[27] Gross income, in turn, is described by specifying certain items which it shall include and exclude. This establishes the outer, the inclusive limits. But it is apparent that this merely describes certain specific sources, the income arising from which is taxed. In the familiar language of the statute, gross income "includes gains, profits, and income derived from salaries, wages or compensation for personal service . . ., of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rents, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits, and income derived from any source whatever."

The first point which impresses one with respect to our statutory concept is its breadth as compared with the concepts used elsewhere. It attempts to draw no line between capital gains and gains of other types. It places no emphasis at all upon the permanence of the source or the regularity of the income. In its general scope it approaches almost to the point of complete identity the working concept of profit used by the accountant. It is by all odds the most theoretically perfect income tax law extant, from the point of view of its general scope. Whether it is, after all, the most scientific

[26] Secs. 210 and 230.
[27] Secs. 212 and 232.

law is another question, for that involves the degree of skill that has been used in modifying the theoretical concept to meet our actual conditions. In that we have not been strikingly successful.

It is interesting to note the dependence which our lawmakers are beginning to place upon the accountants and their standards of practice. The 1918 law, for the first time, specifically directs that certain results be reached by methods in accordance with accepted accounting procedure. This appears to be the modern tendency and is certainly a laudable one. Thus the German Excess Profits Law passed in 1915 is an exceedingly simple document which meets the whole problem of defining profits by stating that they shall be taken to be the "balance of profit duly reckoned in accordance with the legal prescriptions and recognized principles and methods of mercantile accounting." [28]

The net income which our 1918 Act attempts to reach is in the main money income. There are these exceptions: (1) There is a specific provision to the effect that income from personal services "of whatever kind and in whatever form paid" [29] shall be accounted for. (2) Stock dividends are declared taxable but this declaration is nullified by the recent decisions of the Supreme Court. [30] (3) In the case of exchanges, the property received in exchange is "treated as the equivalent of cash to the amount of its fair market value, if any," [31] with the qualification that in the case of reorganizations the transactions are not closed in case the par value of the securities received in exchange for the old securities is not in excess of the securities surrendered.

It will be recalled that our definition demands the taxation of the net accretion of one's power measured in money or money-worth. Should the statute go further than it does in taxing real income even when received in some form other than money? The problem is largely an administrative one. The specific case of the income one really receives when he

[28] *Reichs Gesetzblatt*, No. 187, Year 1915.

[29] Sec. 213.

[30] *Cf. supra*, p. 8.

[31] Sec. 202 (b).

lives in the house he himself owns has become rather acute, the favored position of such an owner being vigorously used by real-estate promoters, particularly those interested in the sale of high-class apartment buildings on the coöperative plan. Such real income should certainly be taxed if it is practicable to evaluate it. The present position is anomalous, particularly when one remembers that such owners, while they may not deduct insurance and upkeep, may, nevertheless, deduct the taxes on the property and the interest on any money they may have borrowed to carry the property. The way to remove the anomaly is to approach the definition of income more closely in practice.

The statute includes as taxable income appreciations of property values, whether those appreciations are in stock-in-trade, in capital assets, or in miscellaneous bits of property owned incidentally. In this it has the sanction of our definition. A distinct departure is made from the definition, however, by the practice of taxing those appreciations only irregularly as sales are consummated, and at the rates in force in the year during which the consummation occurs. This practice lies at the root of the present widespread dissatisfaction with the taxation of appreciations. Our definition demands their taxation whenever they become susceptible of a definite evaluation. A scheme of arbitrary apportionment of the gain over the period of accrual would be infinitely superior to the present practice. With rates varying as they have during the past few years, there has been a tremendous incentive to the business man to resort to methods of postponing the closing of his transactions. The tax on appreciations has in fact operated as a substantial force restraining the alienation of property.

So long as our accounting methods are not equal to the task of furnishing a complete revaluation of assets at the beginning and the close of each accounting period there is no complete solution to this problem. However, unless the administrative burden of the plan of arbitrary apportionment of gains actually made at times of sale is too great to be borne, that plan should certainly be given a trial.

Too much importance may easily be attached to British precedents in determining whether gains from appreciations in property values should or should not be included within the definition of income. The British concept of taxable income, which excludes such gains, is a product of a practical local situation which differs in essential respects from our own. The exclusion of such gains is acknowledged to be illogical and was the cause of much evasion of the Excess Profits Duty. In fact in the administration of that Duty it was found necessary to make important modifications in the direction of the acknowledgment of capital gains and losses as factors in the determination of income.[32] Finally the *Report of the Royal Commission on the Income Tax*, recently submitted, not only recommends the recognition of depletion to a limited extent but urges that, hereafter, gains from incidental business transactions, even where the property which appreciates is not worthy of the designation of "inventory," be included within the scope of taxable income.[33]

There is an interesting incidental point in connection with this problem. We have been accustomed to consider the income tax as one of our elastic taxes whose rates may be conveniently varied to meet the needs of a variable budget. Has not our recent experience with our income tax which taxes appreciation shown that with an income tax of this type variable rates must be avoided until the day of perfect accounting arrives? If the business man were certain that present rates would continue indefinitely, the present game of postponing realizations would quickly cease. On the other hand, it may be well to meet this problem by adopting the British procedure of taxing business profits on the basis of an average of previous years.

The present statute does not regard gifts received by individuals as taxable income. Ordinarily gifts may not be subtracted in arriving at the taxable income of the giver, but charitable contributions made to certain corporations may be deducted by an individual, subject to a fifteen per cent. limitation.

[32] *Cf.* Haig, *The Taxation of Excess Profits in Great Britain*, 1920, pp. 69–73 *et passim*.
[33] *Cmd. 615*, p. 20 *et seq.*, p. 41, *et seq.*

Until recently the Treasury permitted such an individual to deduct from his taxable income the value of the gift when made. This procedure, however, has been changed and he may now subtract merely the original cost or the value on March 1, 1913, if purchased before that date. Gifts to relatives of property upon which one wishes to realize are becoming a common method of evasion, for profit to the recipient is measured from the value of the gift at time of receipt.

In view of suggested legislative action with reference to gifts it is of interest to consider them in relation to the definition as developed above. Are gifts income? Under the terms of the definition, they are if they increase the economic strength of the recipient. But most gifts are either to relatives or to charitable institutions. With respect to family gifts a case may be made out for ignoring the transfer of title on the ground of the essential economic unity of the family. The family, as a matter of fact, is even now to a considerable extent the basic unit for income tax purposes. Gifts to charitable institutions are now, within the fifteen per cent. limit, deductible to the giver and exempt to the recipient. On the ground of public policy much can be said for continuing this practice although it is also true that, speaking in terms of economic fundamentals, the man who makes a gift to some person or corporation outside his immediate family deliberately chooses that way of spending his money because it yields him a greater satisfaction than some alternative use. In any case appreciations in the property given away would, under the proposed definition, become taxable gradually as they emerged in definite enough form to be susceptible of an evaluation.

In summary, then, it must be apparent that the differences among economists as to the definition of income are really more on questions of policy than on questions of principle. There is substantial agreement as to its fundamental character, but some disagreement as to how far the definition ought to be narrowed so as to make it useful for purposes of an income tax base.

The formal definition of *economic* income, which, in the opinion of the writer, provides the most acceptable concept of income, may be stated as follows: *Income is the money-value of the net accretion to economic power between two points of time.* This definition cannot be written into a statute in literal form because of the technical disadvantages in determining income as so defined, but so long as taxable income differs appreciably from this definition there will be anomalies and injustices in income taxation, and every step marking a closer approximation of this definition will result in the elimination of irregular and eccentric results.

The concept of *taxable* income is a living, mutable concept which has varied widely from time to time and from country to country with the conditions under which it has had to operate.

The concept as it stands in our own law is probably the closest approach to true economic income yet achieved by any country. The primary limiting factors are our varying level of prices, our inadequate accounting—including imperfections of valuation, and our incompetence of administration. Possibilities of further progress depend primarily upon our ability to improve our standard of value, our accounting, and our administration.

It is very undesirable from the point of view of economics and equity that the judicial definition of income should develop along narrow lines by the process of definitely eliminating from the concept certain items as not being income. The real question is not often "Is the item income?" but rather "Is the method used for reaching this class of income justified?" In other words, have Congress and the Treasury provided an equitable answer to the practical question as to how and when such income shall be taxed, taking into account the imperfections of the situation in which the tax must function? Under a given statute, is income taxed at such times and in such a manner as to bring about the necessary degree and the highest practicable degree of equity to the taxpayer and between taxpayers? The definition of income should rest on fundamental economic principles. The definition must be

broad enough to iron out all the theoretical difficulties and solve all of the inequities and anomalies. The situation should be held in a mobile, flexible state which will permit the statutory definition of income to become progressively more precise and accurate with the improvement of the technique of our economic environment.

# WHEN IS INCOME REALIZED?

BY

THOMAS S. ADAMS, Ph.D.

When is income realized in the case of taxpayers making return upon the so-called cash or receipts basis? Or, to begin with a more concrete case under this general head—is income realized or received when goods or services are sold on open account or on the personal credit of the purchaser and the taxpayer receives nothing more tangible than a mere claim or chose in action?

A few words may profitably be said in advance about the method of approaching this subject or the terms in which it can best be discussed. The only income under discussion at this point is "income received." But it is now well established that income need not be in the form of money or cash; it is only necessary that the thing received shall be the equivalent of cash. As has been well said, "Returnable and taxable income is that actually realized during the year, evidenced by the receipt of cash or its equivalent." [1] This principle of "cash equivalence" would seem to provide a ready, incisive test of universal application. Has something been received (on income or revenue account, of course) and is it in fact the equivalent of cash? If so, it is taxable. If not, the accounting for taxation must be deferred.

But the subject has not been handled in this simple and elegant way either by the courts or the Treasury. It would be possible to give a long list of cases or questions which have been settled by the courts or by the Treasury without any reference apparently to the question whether the credit, claim or chose in action was in fact the equivalent to cash.

[1] Mimeograph letter to Collectors explaining T. D. 2005, dated August 14, 1914.

Indeed in practical effect, the Treasury goes so far apparently as to regard some payments in specie as unrealized income: "rents received in crop shares shall be returned as of the year in which the crop shares are reduced to money or money equivalent." The regulations dealing with sales on the instalment plan [2] supply another important instance in which the Treasury has in effect disregarded or at least conventionalized the test of cash equivalence. It thus appears necessary to approach this subject in ways more realistic and roundabout than the simple path offered by the test of cash equivalence. Each case or class of cases must be settled on its merits, on its own peculiar facts. We must proceed inductively; and it will be profitable, I believe, first of all to consider the most important class of cases, that of taxpayers engaged in manufacturing, merchandising, and mining who pay one year with another probably sixty per cent. of all the income taxes collected in the United States.

## Manufacturing, Merchandising and Mining Business

In the case of taxpayers engaged in merchandising or manufacturing, the issue here under discussion has been conscious and acute from the very beginning. Indeed it was raised in an important way before the passage of the special excise tax (with respect to corporation income) of August 5, 1909. Under date of July 8, 1909, twelve of the most prominent firms of accountants of the country in a carefully framed communication addressed to George W. Wickersham, Attorney General, vigorously protested that the phraseology of the proposed law, dealing with "income received" and "expenses actually paid," was unsuited to modern business, "that the law as framed" was "absolutely impossible of application," and suggesting that "the words 'actually paid' and 'actually sustained' be changed to read 'actually incurred' and 'actually ascertained' . . ." This correspondence with the Attorney General well repays careful reading. In a second letter

[2] Reg. 45, Art. 42–46.

dated July 21, 1909, the accountants suggest that it would be "better to use the term 'receipts on income account' and 'disbursements on income account' rather than 'income' and 'expense,' as the latter terms are more commonly defined and used in relation to income earned and expenses incurred." And they stated the reasons, in technical accounting phraseology, which prove that in the case of a large manufacturing concern it is a practical impossibility to compute on a strictly receipts basis the amount of net income.

In answer to these representations the Attorney General replied that "the bill was purposely framed to deal with receipts and disbursements made within the year for which the tax was to be imposed, and the words 'actually paid' were employed advisedly. The same may be said with respect to losses actually sustained and interest actually paid. The theory of the framers of the bill in this respect differs from that which you advocate." This theory finally prevailed. The bill as adopted was couched in terms of income received and expenses paid.

Notwithstanding the deliberate rejection of the suggestions of the accountants in question, both by the Attorney General and by the committees of Congress charged with the duty of formulating the law, and notwithstanding the fact that the Government had no particular pecuniary interest in deciding this question one way or the other (inasmuch as in the long run a strict cash accounting would yield approximately the same revenue as an accrual accounting and probably a little more), the regulations adopted the theory of the accountants and not that of the Attorney General. Taxpayers of this class were required to compute gross income received "through an accounting that shows the difference between the price received for the goods sold and the cost of such goods as manufactured," and it was further stated:

> It is immaterial whether any item of gross income is evidenced by cash receipts during the year or in such other manner as to entitle it to proper entry on the books of the corporation from January 1 to December 31 for the year in which return is made.[3]

[3] Reg. No. 31, dated December 3, 1909, Art. 2, par. 3, 4, 5 and Art. 4.

It is not necessary here to follow in detail the subsequent regulations and rulings of the Treasury relating to computation of income received by such taxpayers. Under all the income tax laws, they have consistently and practically without exception required taxpayers to compute income on the basis of total sales, whether the sale price had been actually received—or the payments actually made—or not. Of course no taxpayer has been compelled to include in his gross income claims or accounts receivable which were not the equivalent of cash. "Debts ascertained to be worthless and charged off within the taxable year" could be subtracted; and in the language of present regulations[4]:

> If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair market value when received, which may be less than their fair market value, the amount deductible for bad debts in any case is limited to such original valuation.

Yet it is true in substance that from the adoption of the special excise tax of August 5, 1909, with respect to the most important class of taxpayers subject to the tax, accounts receivable and bills receivable have been, compulsorily, treated as income received at the time set up or accepted unless it could be demonstrated that they were not the equivalent of cash.[5]

Why in the case of manufacturing and merchandising did the Treasury depart so radically from the views expressed by Attorney General Wickersham? As stated above, the Government had no greater pecuniary interest in one interpretation than the other. The Treasury endeavors in good faith—according to my experience—to accept and enforce the real intent of Congress as revealed in the language of the statute.

First of all it may be noted that the interpretation of the law implicit in the regulations was urged upon the Treasury by the business interests concerned. It was the convenient and practical way of computing net income. It may be added that this regulation has never been questioned in the courts,

[4] Art. 151.

[5] I. T. S., 1916, ¶ 1101, p. 213.

so far as I know, and has never been the subject of protest from the taxpayers of the country.

As a matter of mere language, moreover, the regulations prescribe the procedure followed by a very large majority of mercantile and manufacturing concerns in computing the thing which is commonly called "income," the income which they report to their bankers and (in the case of corporations) to their stockholders. It has been repeatedly held that the word income as used in the Sixteenth Amendment and the statutes enacted in pursuance thereof has been used in its common ordinary meaning. The letter of the accountants referred to, under date of July 21, 1909, bears unconscious and very valuable evidence of the common ordinary meaning of the word income as used in connection with manufacturing and mercantile accounts:

> Under these circumstances it would seem better to use the term "receipts on income account" and "disbursements on income account" rather than "income" and "expense," as the latter terms are more commonly defined and used in relation to income earned and expenses incurred.

In short the word income in manufacturing and mercantile business carries usually and inevitably certain accrual implications. In businesses of any magnitude it is the only basis for computing net income which is practicable or possible. The concept in the mind of Attorney General Wickersham is connoted by the word receipts or gross receipts, not by the word income.

The reasons for the preceding statement may be easily seen. The income of the average manufacturing or mercantile business consists principally of profits. To compute profits there must be a deduction of the cost of the thing sold from the amount for which it has been sold. In the multitudinous transactions of the average mercantile or manufacturing business, however, costs must be computed in the aggregate, for a volume of business occurring during a specified period of time, by the use of inventories and similar devices. (The case is, of course, quite different for major items of capital, cost records for which are separately kept). The only time that

aggregate costs can be accurately computed is during or at the end of the accounting period in which the sales are made. It is impracticable to subtract costs at the time collections are made. Collections string along over long and different periods of time, purchasers frequently pay in one check for goods or services bought in different years or different accounting periods. In short, for fairly obvious reasons, modern business cannot measure its income on the basis of collections minus the costs and expenses assignable to the goods and services paid for but, on the contrary, must make the reckoning during or for the accounting period in which the sales are made, treating book accounts, bills receivable and like credits as items of true income—property received in exchange for property or service rendered—and treating the similar obligations assumed by the taxpayer as items of real expense or outgo.

Expressed in the language of accounting the considerations alluded to above were thus formulated in the letters of the accountants mentioned to Attorney General Wickersham:

> Turning now from this, which is perhaps the most simple case, to that of a large manufacturing concern producing all kinds of finished products out of purchases of ore and other raw materials, an accurate or even approximate statement of cash receipts and disbursements on income account is a practical impossibility at any time. Cash receipts arising from sales of products can be ascertained without much difficulty, beyond requiring considerable extra work. But no system of accounting can give even approximately "the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties." Such expenses presumably must include the cost of the goods sold. Into this cost and following it through the intricate accounting which has been found to be necessary are raw materials actually used in manufacture, labor expended, and innumerable items of expense, which are taken into costs as they accrue quite irrespective of the date of payment. Very large inventories are carried of materials and supplies which are purchased at one period, paid for at another, and used at all sorts of times, in all sorts of quantities, and for all sorts of purposes, mainly for manufacture into products for sale, but to a large extent for additions to or extensions of the plant. Such as are used for the latter purpose are not, as we understand the proposed law, a proper deduction from gross income, and yet, long before they are used all identity between the materials themselves and the disbursements made for them has been lost. There is, in our opinion, no method in which any statement such as that called for in the proposed law can be prepared short of an

entirely independent and separate set of books, designed to follow each bill paid through to the ultimate destination of the materials or services covered thereby, thus duplicating the present cost of the accounting department and serving no useful purpose whatever. Even if such method were adopted, it is very doubtful if it would produce the results required with even approximate accuracy.

I have elaborated at undue length perhaps the point here under discussion. But the gravity of the situation justifies the space devoted to the subject. The courts have recently in an increasing number of cases repeated with approval the finding in United States *v.* Schillinger[6]: "In the absence of any special provision of law to the contrary, income must be taken to mean money, and not the expectation of receiving it, or the right to receive it, at a future time." This means if applied literally to returns of merchants and manufacturers that most, and the most important, assessments made under laws prior to the Revenue Act of 1918 are invalid. To attempt to correct these assessments would cause grave confusion and it would subject the taxpayers concerned to other real hardship.

Prior to 1919 federal tax rates rose rapidly. Collections followed sales in point of time. Much of the war profit, so-called, was taxed at the lower rates applicable to the years in which the sales were made. If these profits must be taxed in the year in which collections were made the taxes would be very much heavier. And the situation does not correct itself at the other end. By the time tax rates were reduced accrual accounting was formally entrenched in the tax law.[7] The conclusion which I believe to be sound and which I deeply hope will commend itself to the wisdom of the courts is that, in interpreting the words "income received," trade practice and procedure should be followed when a prevailing trade practice may be fairly said to be discoverable. I believe there is no such established practice in the treatment of income derived from sales of personal service on which the courts have already spoken, but there is a prevailing practice among merchants and manufacturers and it is that which is embodied

[6] 14 Blatchf., 27 Fed. Case No. 16, 341.
[7] 1918 law, Sec. 212.

in the regulations. Expressed in terms of the doctrine of "cash equivalence"[8] the conclusion seems to be that the receivables and other claims created in the course of an ordinary mercantile or manufacturing business are in fact and should be treated as the "equivalent of cash," unless and to the extent that the contrary is shown. That they are the equivalent of cash is proved (1) by the small percentage of uncollectible or bad accounts found in the average business, (2) by the willingness if not the obvious desire of this class of taxpayers to pay on the basis prescribed by the regulations, and (3) by the whole purpose and object of business which is to exchange goods or services for cash or credit, and usually for credit rather than cash.

### Instalment Sales, Farming, Contracting and Construction Companies

In the case of merchants and manufacturers, income is principally profit; profit cannot be computed without deducting cost of sales; the only practical way of computing the latter is through the use of inventories or their equivalent; inventories can be taken only at the end of the accounting period (usually perhaps a year), and this forces the computation of income or profit to be based on the sales of the accounting period whether the corresponding accounts have been actually collected or received within that accounting period or not. This, as I consider it, is the necessary logic of the situation. This logic has found expression in the prevailing trade or commercial practice, and the departmental regulations relating to merchants and manufacturers thus rest—I trust they will be found eventually to rest *securely* both as a matter of law and equity—on the two pillars of commercial logic and commercial practice. Where either of these supports is lacking the regulations and rulings of the Treasury usually permit the taxpayer to report on the cash or receipts basis; and where the doctrine of the Treasury has changed or evolved it has usually been in the direction of a wider acceptance of the cash or receipts basis.

[8] 1918 law, Sec. 202 (b).

*Instalment Sales and Sales Involving Deferred Payments.* Until the issuance of Regulations 45 relating to the Revenue Act of 1918, the Treasury appears to have held consistently that profits arising from such sales must be reported in the year in which the sale was made, *i. e.*, when the title passed. Under existing regulations, however, taxpayers are given a wide option. In this case a compulsory non-cash method has been replaced by an optional cash method, and this is not due to the passage of new legislation, since the change in the law has been in the opposite direction, *i. e.*, towards the strengthening of accrual accounting for tax purposes.

T.D. 2090 (December 14, 1914) contains under the caption "Profit from sale of real estate" the following paragraph:

> For income tax purposes, where there is an actual sale and transfer, profit will be considered as realized even though payment is to be made in instalments, as notes for deferred payments are secured by the title to the property, and presumably bear interest and are held to be worth, in cash, their face value.

In Regulations No. 33 (Revised) governing the collection of the income tax imposed by the Act of September 8, 1916, as amended by the Act of October 3, 1917, the above doctrine was retained for instalment sales of personal property and real estate in which title passed at the time of the sale, but the cash instalment method was recognized for such sales when title remained in the vendor until the contract price was fully paid.[9]

Under existing regulations the test based upon passage of title has been practically disregarded with respect to sales both of real estate and personal property where initial payments of a substantial nature are not made, and within wide limits the taxpayer is given an option either to return the entire profit when the sale is originally made or to report profit ratably as the actual cash collections are made.[10] The rule or test employed in the regulations is whether the

[9] *Cf.* Reg. No. 33 (Revised), Arts. 116, 117, and 120.
[10] *Cf.* Reg. 45, Arts. 42, 44, 45, and 46.

obligations assumed by the purchasers or buyers "are ordinarily to be regarded as the equivalent of cash." The use of the word "ordinarily" here is very significant. The test is not applied in each individual case but the rule is based upon the general character of this class of sales as determined by experience and as exemplified in the accounting methods of taxpayers engaged in this class of business. A taxpayer would consequently be entitled to use the ratable cash basis here even though in a particular sale the obligations assumed by the buyer were unquestionably the equivalent of cash.[11]

*Farming.* Farming affords an illustration of a business in which the "necessary logic" would perhaps require an accounting on the basis of sales as distinguished from receipts, but as the accounting practice (or lack of practice) in this business would not justify such a requirement, the Treasury Department has accepted from the beginning the crudest forms of cash accounting, although as early as February 12, 1915,[12] "farmers who keep books according to some method of accounting" were given the most liberal option to "prepare their returns from such books." The language of some of the regulations might possibly be construed to mean that income was to be returned when the sale was made, whether for cash or credit, but the forms and the official correspondence prove that the most naïve form of cash (income) accounting was contemplated. Here, again, the regulations rest not so much upon a judgment in individual cases as to whether the obligation assumed by the purchaser is the equivalent of cash, but upon established practice among agricultural classes regarding the computation of the thing commonly called income.

*Contracting Companies.* In this business costs are ordinarily kept by contracts or jobs and it is consequently easy to compute profit on the basis and at the time of collections or completed contracts. The actual accounting practice among

[11] I believe, however, that the reverse would not hold true, *i. e.*, that a taxpayer in one of the classes required by these articles to report the profit at the time the sale was made would not be so required in case he could demonstrate that the obligation had no fair market value or was not actually equivalent to cash.

[12] *Cf.* T. D. 2153.

contractors differs. Accordingly, the Treasury has from the beginning [13] accepted from such taxpayers an extreme form of cash accounting, although an elastic form of an accrual accounting has also been recognized. The form of cash accounting authorized is interesting and peculiar. Apparently the taxpayer is permitted to wait until payment for the work is actually received, but then it must be "returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from gross income should be limited to the expenditures made on account of such completed contracts." [14] This illustrates the device of an "account with the taxpayer," utilized with good results in Great Britain.

## Isolated Sales of Capital Assets—Are Claims So Created Income When Received?

The preceding examination of the method of computing income reveals an evident effort to follow trade practice, with the result that a particular method has been prescribed or required when what may be called a prevalent practice has been discerned in a given trade or business, while an option has been given to any trade or business in which the practice is fundamentally diverse. It will be noted, however, that these rules apply in general to dealers or to individuals regularly receiving the kind of income in question. They apply particularly to mass transactions—to a volume of sales or to recurring receipts of the same kind. Moreover, the fact that the taxpayer is dealing with a volume or mass of transactions is important. There is safety in numbers. It is reasonable, for instance, to require a taxpayer to treat the entire body of his book accounts for a taxable year as a substantial equivalent of cash,[15] where it might not be reasonable to require him to

[13] T. D. 2161; February 19, 1915.

[14] Reg. No. 33 (Revised), Art. 121, issued January 2, 1918. *Cf.* T. D. 2161, February 19, 1915; also Reg. 45, Art. 36.

[15] Particularly when he is permitted to compute "his income upon the basis of valuing his notes or accounts receivable at their fair market value when received." Art. 151.

treat a particular account as the equivalent of cash. If the taxpayer regularly by choice sells on open account, it is obvious that he regards the average book account at least as the equivalent of cash. Where in case of instalment sales the average book account is not the equivalent of cash a method of cash accounting is accepted.

We come now to consider isolated or casual sales, for the treatment of which there is, so far as the writer knows, no established trade practice and in respect of which the particular taxpayer cannot well be offered an option on the condition that he deals with such transactions consistently from year to year, since the isolated character of the transaction affords no opportunity for consistent treatment.

The practice of the Treasury in connection with the sale of capital assets has apparently been consistent and unvarying from the adoption of the Act of August 5, 1909, to the present time. Regulations No. 31, issued December 3, 1909, provided that the taxable gain from such sales should be "added to the gross income for the year in which the sale was made," and that direction has been repeated in all the regulations issued from that time to the present date.[16] The latest regulations are in terms confined to corporations and in the earlier regulations much stress was laid upon the treatment of such gains on the taxpayer's books of account. Thus in a much quoted Treasury letter to Carey, Piper and Hall, dated March 2, 1915, it was stated that:

> Accounts and bills receivable of a corporation are to be treated as income for the year in which they are created, that is to say, in the year in which the accounts are set up on the books or the bills receivable are accepted.

However, I believe that the rule has been the same for all taxpayers; that in all cases a presumption existed that the gain was returnable and taxable for the year in which the sale was made, but that this presumption could be defeated by proof that the claim or the obligation assumed by the purchaser was not in fact the equivalent of cash.

[16] Art. 545.

## Compensation for Personal Service, Interest, Rents and Dividends[17]

The specific question here under discussion is whether wages, salaries, rent or interest due in one taxable year, but paid in another, are income for the year in which due. On this precise point the more formal regulations and Treasury decisions have been somewhat evasive, but in repeated letters to taxpayers which have been given wide circulation and in its more informal rulings the Treasury has made it clear that the taxpayer was expected to report such income not when due, but when actually or constructively received by him.[18] The language of some of these rulings even suggest that taxpayers keeping books on an accrual basis, with respect to income accrued before January 1, 1918, would be permitted to return such items on the cash basis.[19]

The Treasury has approached very close to the doctrine that collectible claims for due but unpaid wages, salaries, interest and rent become income when created. Payments of this class when made in liberty bonds, corporate stock, or promissory notes (received in payment and not merely as security for payment); dividends and interest paid in scrip; living quarters furnished in addition to salary, and not "for the convenience of the employer," have been held to be income for the year in which received or furnished.[20] A doctrine of constructive receipt has been developed under which interest coupons which have matured, dividends which have been set apart for the stockholder, interest which has been credited on savings bank deposits, amounts which have been credited without restriction to the shareholders of building and loan associations, but not actually collected, are income for the year in which so credited or made available.[21] This doctrine

[17] The special provisions for taxing certain dividends at the rates prescribed for the years in which the profits or surplus were accumulated are not here reviewed.

[18] *Cf.* I. T. S. 1919, ¶¶ 887, 920, 921, 922, 923.

[19] Income Tax Primer, as Revised March 1, 1919, ss. 23, 24.

[20] With respect to dividends it has been held (I. T. R. 140) that "the date of payment rather than the date of receipt is the governing factor in determining when a dividend should be treated as taxable income to the recipient."

[21] Arts. 53, 54.

has been applied to compensation for personal service.[22] But except in a few isolated cases,[23] obviously contrary to the great majority of rulings, the Treasury has not treated wages, salaries, rent or interest due but unpaid as income, even though the claim or obligation were unquestionably the equivalent of cash.

The difference in the Treasury attitude towards such income and gains or profits derived from the sale of property is partly ascribable to court decisions reviewed hereafter, but in the main is due, I believe, to the probable fact that a majority of the persons who receive wages, salaries, fees, rent, interest and dividends treat them as income only when actual payment is made. Many corporations and business concerns take them up on their books when due or even as they are earned, it is true, but the prevailing practice—if any can be said to exist—probably inclines to the cash basis; and this was even more true in the past than at present. However, it is past practice rather than present practice which fixes the connotations of words, particularly in the legal interpretation. Nor is there the same logical or practical necessity to treat wages, interest and the like as income when due. In computing the net income derived from these items, inventories do not figure at all, and the deductions for cost and expense are comparatively unimportant, frequently absent altogether. When property is parted with in exchange, intelligent bookkeeping makes it practically necessary to set up on the books a corresponding asset and it can hardly be set up without being constructively regarded as "received." But when personal service is sold for wages or a fee, or when the use of capital is parted with for interest, no "asset goes out" in like sense, to balance which an incoming asset must be recognized. In short the logic and the practice are not the same as in the case of income derived from sales of property.

## Rationale of the Treasury Regulations

Surveying all the Treasury regulations which have here been reviewed, from those relating to merchants' sales to those

[22] I. T. S. 1919, ¶ 858.
[23] *Cf.* ruling discussed in Edwards *v.* Keith, 231 Fed. 110.

affecting wages and interest, it will be seen that they create a set of initial presumptions which in turn rest upon practice, logic and administrative necessity. Merchants and manufacturers are presumed to compute net income on the basis of all sales, but are permitted to value or appraise the corresponding accounts or bills receivable when created or to write them off when ascertained to be worthless. Instalment dealers and farmers and those who sell real estate on small initial payment, along with those who receive salaries, wages, fees, rents and dividends, have been presumed to report on a cash basis but are permitted, if they follow the practice consistently, to report on an accrual basis. Sales of capital assets, when a substantial part of the consideration is paid in cash, are presumed to create income when the sale is consummated; but even here the vendor may, I believe, avoid the presumption by proving that the consideration is not or was not in fact the equivalent of cash. The test or principle of cash equivalence has been applied mercifully if not rigidly or consistently. Where the initial presumption treats the credit or claim as income, the taxpayer has been permitted to disregard the presumption by proving that the claim is not the equivalent of cash. Where the presumption was the other way, the taxpayer who kept books on the accrual basis was permitted to follow his books.[24] In these cases, however, in which the cash basis was presumed, the Treasury did not reserve nor exercise the right to defeat the presumption that the claim was not the equivalent of cash, by proving the contrary.

These presumptions follow as closely as practicable, I believe, the prevailing practice among the classes concerned, in so far as it is possible to see that any particular practice "prevails." Taxpaying and tax-gathering constitute an eminently practical trade which must be conducted on a wholesale scale. Rules applicable to millions of taxpayers, to be enforced by thousands of governmental employees, not always expert or thoroughly trained, must adhere in the main to prevailing practice. There is no real choice to do otherwise. The Sixteenth Amendment did not, I take it, authorize the

[24] He was not required to follow them until the Revenue Act of 1918 took effect.

taxation (without apportionment) of some mystical quantum—"income"—which never was on land or sea. It authorized the levy and collection of a workable tax of so much practicable importance that it is only a slight exaggeration to say that without its use in some form no modern nation can wage or win a major war. Rules and regulations which do not follow practice—indeed which do not adapt themselves elastically to the variations of practice—will simply be disregarded in the great mass of cases. All this is too often forgotten by taxpayers, economists, administrative officials and the courts. After all, when everything has been said and the resources of legal procedure, accounting logic, and economic principle have been exhausted, the great—perhaps the controlling—fact remains that a great tax is to be collected from millions of taxpayers, and the only way that this can be successfully accomplished is by adapting its terms to prevailing usage among the taxpayers affected.

It is worthy of note that the practice or custom within particular industries or callings is not always a matter of general knowledge. An investigation of the actual facts frequently surprises people who have a very wide and accurate knowledge of business practice. To make regulations or to decide cases by processes of formal verbal logic and to assume that the meaning of the words "income received" is plain to all men, is either to lay down rules which will be almost universally flouted by taxpayers, or to throw the administration of the tax into such confusion as to endanger its continued use. "Income received means income received—that is all there is to it," is apparently a simple way out of the dilemma. In my opinion it is neither a simple nor a practicable way out. There is a truer simplicity in the effort to follow the practices of different classes of taxpayers in computing the thing which they report to their banks and creditors and their stockholders as net income; and the effort of the Treasury—groping and mistaken at times without doubt—to follow the winding paths of practice and usage is, I believe, as wise as it is in the long run unavoidable. The Treasury is not free to make such regulations as to it seem wise and fit; it is controlled not only

by the statute and the courts but it is dominated by inexorable administrative necessities.

## Court Decisions

The regulations of the Treasury have been examined at some length in order to emphasize the foundations upon which they rest—commercial practice, common usage and administrative necessity. No exhaustive review of the court decisions is possible at this place. They have been collected and may be conveniently examined in the current manuals.[25]

These decisions appear to determine definitely the law on this subject as it relates to compensation for personal service, fees, commissions, insurance premiums, interest and dividends. They rest for the most part upon the "natural and obvious" or the "ordinary and popular" meaning of the words "income received" or "income derived." The following citation from a decision of the Court of Claims of the United States approved (rather silently so far as this particular point is concerned) by the Supreme Court of the United States is perhaps typical:

> The word "income" as used in revenue legislation, has a settled legal meaning. The courts have uniformly construed it to include only the receipt of actual cash as opposed to contemplated revenue due but unpaid, unless a contrary purpose is manifest from the language of the statute. What is taxed by the terms of the foregoing statutes is "net income received," not income accruing or accrued which has not been received and portions of which may never be received. While the phrases "income received" and "income accrued" are frequently used in the same statute, the courts have not departed, unless it expressly appears otherwise, from a construction of the law in accord with an intention to reach the actual and not the potential income of the corporation. In the income-taxing act of 1913 (38 Stat. L., 172) the two preceding phrases are employed; in fact, the act of 1913, in speaking of incomes as applied to insurance companies and domestic corporations, uses the above phrases as follows: "Income arising or accruing," "income received," and "income accrued." Doubtless it was the intention of Congress in legislation of this character to employ terms of sufficient comprehension to reach the actual income of the corporation by foreclosing any possible avenue of escape, but it can hardly be said that in so doing an intention prevailed to tax that which did not actually exist, except on paper, as income accrued during the

[25] Particularly Holmes, *Federal Taxes*, chap. 14. *Cf.* also *Notes on the Revenue Act of 1918, etc.*

taxing period. One can not be said to receive an income of defined proportions until he balances receipts and deductions at the end of a stated period and ascertains not what is due but what has been actually received. The assets and liabilities of a corporation may be measured by a different rule of accounting, but income as defined by the courts means, as said in *United States v. Schillinger* (14 Blatchf., 71), "in the absence of any special law to the contrary, income must be taken to mean money, and not the expectation of receiving it or the right to receive it at a future time." [26]

In the Schillinger case referred to above it was held that "where the effect of transaction is a mere promise to pay and not an actual payment it cannot be said to be income until it has been actually received and is not subject to be taxed as such until it is actually received." [27] In this case certain patent rights were exchanged or "changed" for promissory notes which were duly paid, although the Court said "their value was uncertain; they might or might not be paid; but until they were paid, they were not income, but only the ground of expecting income."

These decisions raise an exceedingly serious question. Probably sixty per cent. of the income taxes which have been collected since 1909 have been based upon sales as made and not upon receipts as collected. Must we therefore conclude that the regulations as they related to merchants and manufacturers have been wrong, that the tax in all these cases has been incorrectly computed, and that the assessments are invalid?

Grounds for the belief that these conclusions do not necessarily apply to profits derived from the sale of property, particularly stock-in-trade of merchants and manufacturers, may be found in the case of *Hays v. Gauley Mountain Coal Company*,[28] and *Doyle v. Mitchell Bros. Company*.[29] In the former case the Court, doubtless using the words in "their natural and obvious sense" or in the "ordinary and popular acceptation," speaks repeatedly of appreciation in the value of property before sale as "accrued income." For example the Court said: "The expression 'income received during such

[26] Maryland Casualty Co. *v.* U. S. 52 Ct. Cls. 201; T. D. 2451.

[27] *Cf. supra.*

[28] 247 U. S. 189.

[29] 247 U. S. 179.

year', employed in the act of 1909, looks to the time of realization rather than the period of accruement, except as the taking effect of the Act on a specified date (January 1, 1909) excludes income that accrued before that date." As evidence of the "natural and obvious sense" of words, the repeated use of the term "accrued income" in this decision throws doubt upon extreme statements which have been made by some of the lower courts to the effect that there can be no such thing as income until actual payment has been made in money or something other than a mere promise to pay. Moreover, if it were necessary, a strong argument could be made for the contention that, to justify all of the conclusions reached by the Supreme Court in these and related cases, it is essential to hold that income or profit may arise or accrue before sale. However, involved reasoning would be out of place in dealing with a question which turns largely on the meaning of words, particularly in view of the peculiar finding in the case of *Lynch v. Turrish*[30] which makes it doubtful whether appreciation in the value of capital assets is income at all. Yet even in that case the Court held: "If increase in the value of the lands was income it had its particular time, and such time must have been within the time of the law to be subject to the law, that is, it must have been after March 1, 1913.

In short, there may be income even before sale. *A fortiori*, there may be income before final payment in cash. If, then, mere appreciation in value is accrued income, what sort of income arises when sale is made, and title to the property passes to the purchaser, even though he has paid only with a note or a mere promise; is this intermediate form of income "received" or merely "accrued" in another sense? It is my task to show, if possible, that, in the case of dealings in property, particularly mass dealings or sales for an entire year, it may be held to be received or realized income.

I find the most support for that belief in the case of *Doyle v. Mitchell Bros. Company*.[31] The circumstances of that case are

[30] 247 U. S. 221.
[31] *Cf. supra*, p. 46.

familiar and I shall not dwell upon them except to emphasize the fact that it was a lumber manufacturing corporation, whose stumpage or timber had appreciated in value between the purchase date in 1903 and December 31, 1908; and that the question involved was whether in computing taxable profit on sale there should be deducted the cost of the stumpage in 1903 or its value on December 31, 1908. It was held in this case:

Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of "income," it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in *Stratton's Independence v. Howbert* (231 U. S. 399, 415); "Income may be defined as the gain derived from capital, from labor, or from both combined."

Understanding the term in this natural and obvious sense, it can not be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the "gross income" received "from all sources," and by applying to this the authorized deductions we arrive at "net income." In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

This has been recognized from the beginning by the administrative officers of the Government. Shortly after the passage of the act, and before the time (March 1, 1910) for making the first returns of income, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, promulgated Regulations No. 31, under date December 3, 1909, for the guidance of collectors and other subordinate officers in the performance of their duties under the act. These prescribed, with respect to manufacturing companies, that gross income should consist of the difference between the price received for the goods as sold and the cost of such goods as manufactured; cost to be "ascertained by an addition of a charge to the account of the cost of goods as manufactured during the year of the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year." In the case of mercantile companies, gross income was to be the "amount ascertained through inventory, or its equivalent, which shows the difference between the price received for goods sold and the cost of goods purchased during the year, with an addition of a charge to the account of

the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year." And as to miscellaneous corporations, gross income was to be "the gross revenue derived from the operation and management of the business and property of the corporation," with all income derived from other sources. The matter of income arising from a profitable sale of capital assets was dealt with specifically in such a way as to limit the tax to income arising after the effective date of the act. This was done by adopting the rule that an advance in value arising during a period of years should be so adjusted that only so much as properly was attributable to the time subsequent to January 1, 1909 (December 31, 1908, would have been more precise), should be subjected to the tax.

At this point the Court quoted that paragraph from Treasury Regulations No. 31, issued December 3, 1909, which deals with "Sale of Capital Assets."

Now these regulations, quoted with approval by the Court, have been in substance maintained by the Treasury from that time to this. The Court apparently recognizes the necessity of employing inventories. The use of inventories necessarily involves a deduction of the cost of goods which have left the establishment, *i.e.*, which have been sold. Surely the Court did not contemplate that the cost of all goods sold should be deducted without including the selling prices of all goods sold whether paid for in money or not. I stress this point because the language of the regulations in question on first reading is ambiguous. The regulations speak of "an accounting that shows the difference between the *price received*[32] for the goods sold and the cost of such goods as manufactured." A reading of the regulations will show that the words "price received" do not mean money actually received. The regulations quoted by the Court were followed almost immediately by this statement:

It will be noted from these definitions that gross income is practically the same as gross profits, the only difference being that gross income is more inclusive, embracing as it does not only gross profits of the corporation, joint-stock company and association itself, but also all amounts of income received from other sources. It is immaterial whether any item of gross income is evidenced by cash receipts during the year or in such other manner as to entitle it to proper entry on the books of the corporation from January 1 to December 31 for the year in which return is made.

[32] Italics are the writer's.

Similarly the regulations relating to deductions include the following statement:

> It is immaterial whether the deductions are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books as to constitute a liability against the assets of the corporation, joint-stock company, association, or insurance company making the return.

Surveying this decision in its entirety, it is hardly too much to say that it recognizes those familiar processes customarily and usually employed in computing the profits or net income of manufacturing companies. I think that it justifies the Treasury in not disturbing the general attitude which it has in the past taken towards commercial profit. The whole question is a technical and difficult one. It would be unjustifiable in view of this decision for the Treasury to break faith with hundreds of thousands of taxpayers, call upon them for a new and different accounting and compute taxes on the basis of collections rather than sales in the case of business concerns. Commercial usage is so plain in such cases that it is not to be overcome by rulings relating to interest, dividends, commissions, fees, and insurance premiums. Looking to this case as well as to the findings in *Hays v. Gauley Mountain Coal Company*, *Lynch v. Hornby*,[33] and *Lynch v. Turrish*, I believe the Treasury is justified in holding that the entire body of accounts and bills receivable representing goods sold on credit during a year may be said upon the sale and acceptance of the corresponding goods to have become capital assets replacing those goods, and to have passed through the door of income in becoming capital assets.

[33] 247 U. S. 339.

# CONSTITUTIONAL ASPECTS OF FEDERAL INCOME TAXATION

BY

Thomas Reed Powell, LL.B., Ph.D.

It seems somewhat the fashion to begin a paper by exalting the importance of the subject which it is to treat. It may be thought that the subject will appreciate the compliment and in some mysterious way gratefully bestow on the paper an importance it would not otherwise enjoy. Much as my paper needs all such help that it can get, candor compels me to belittle its subject rather than to flatter it. The constitutional aspects of federal income taxation are relatively unimportant. Now and then the Supreme Court may find in the Constitution an obstacle to some particular exercise of the federal taxing power; but these occasions will be few in comparison with those in which taxes obviously objectionable on practical grounds will be found free from constitutional fault. Among foolish propensities, high rank must be given to the instinct to exalt one's aversions by assuming that they are shared by the Constitution of the United States. The pastime is worse than futile; it is often positively harmful. It leads the opponents of legislative programs to indulge in bad constitutional arguments to the neglect of good practical ones. By and large the Constitution marks only the outside limits of unwise legislation. It leaves to our Solons a broad and fertile field for folly. Some of you can doubtless think of instances where this license has been availed of. Some of you may discern the danger of more indulgences in the near future. If you wish to restrict these to the minimum of which Congress is capable, you will do well to put forth your wisdom in its naked state, without troubling to tog it out in constitutional garb. Have recourse to the Constitution only when all other comforts fail.

This advice has special application to objections that the federal government is seeking to include in the assessment of an income tax something that is not technically income. Our doctors of economics are not yet in such happy accord that with singleness of voice they can advise the Supreme Court as to the one and only right definition of economic income. Their mode of reasoning sometimes reminds one of Professor Sumner's wise saying that you can get out of a major premise all that you put into it. It is not hard to concoct an *a priori* concept which makes a perfect chrysalis for a contemplated conclusion. No such concept is inexorably true under all circumstances or for all purposes. There are always other available concepts for those who wish other results. Moreover, courts are not bound to accept economic concepts however perfectly they please the economists.[1] Legal income and economic income are not invariably identical. For example, gain must be an essential element in economic income. One who merely gets back part of his capital in a changed form can hardly be said to have received economic income. Yet payments of cash [2] and property [3] by a corporation to a stockholder have been held income within the Sixteenth Amendment though they made him no richer than he was before the Amendment was in force. Income from capital which is an impairment of capital and not a gain therefrom must be an anomaly to the economist. It is not an anomaly in law. Reasons of practical convenience for treating the corporation and the stockholder as distinct individualities are accepted by the Supreme Court as adequate for a concept of legal income which violates sound principles of economic income. The Constitution is construed to permit

[1] Compare Mr. Justice Peckham in Nicol *v.* Ames (1899) 173 U. S. 509, 515–516: "In deciding upon the validity of a tax with reference to these requirements, no microscopic examination as to the purely economic or theoretical nature of the tax should be indulged in for the purpose of placing it in a category which would invalidate the tax. . . Taxation is eminently practical, and is in fact brought to every man's door, and for the purpose of deciding upon its validity a tax should be regarded in its actual, practical results, rather than with reference to those theoretical or abstract ideas whose correctness is the subject of dispute and contradiction among those who are experts in the science of political economy."

[2] Lynch *v.* Hornby (1918) 247 U. S. 339.

[3] Peabody *v.* Eisner (1918) 247 U. S. 347.

the taxation, as income from capital, of what a man cannot spend without depleting his capital. So one should be cautious in substituting contentions based on the Constitution for contentions based on common sense.

I

A still broader reason for the relative unimportance of federal income taxation is that the federal government is not confined to the taxation of income. True, in so far as its power depends upon the Sixteenth Amendment, it can assess only what the Supreme Court thinks may reasonably be regarded as income, or possibly only what the Supreme Court thinks is really income. But without the aid of the Sixteenth Amendment, the federal government has extensive fiscal powers. This was made clear in the first case [4] which dealt with the Corporation Excise Tax of 1909. The Sixteenth Amendment [5] was not then in existence. The Pollock Case [6] was still the law of the land. Under it Congress could not levy an unapportioned tax on income from state or municipal bonds or on income from real or personal property. The restriction on taxing income from state and municipal bonds was predicated on the long-established principle that neither the states nor the United States may exercise their undoubted powers over the undoubted powers of the other.[7] Income from property was sheltered for the reason that a tax on income was regarded as in substance a tax on the source of the income. As a tax on property was concededly a direct tax, a tax on the income therefrom was put in the same class. But a tax on business

[4] Flint *v.* Stone Tracy Co. (1911) 220 U. S. 107.

[5] The Amendment was ratified by the requisite number of states on February 3, 1913, and on February 25, 1913, Secretary of State Knox certified that it had become a part of the Constitution. It reads as follows: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

[6] Pollock *v.* Farmers' Loan & Trust Co. (1895) 157 U. S. 429, 158 U. S. 601.

[7] M'Culloch *v.* Maryland (1819) 4 Wheat. 316; Weston *v.* Charleston (1829) 2 Pet. 449; Dobbins *v.* Erie County (1842) 16 Pet. 435; Bank of Commerce *v.* New York City (1862) 2 Black 620; Bank Tax Case (1864) 2 Wall. 200; Collector *v.* Day (1871) 11 Wall. 113; United States *v.* Railroad Co. (1873) 17 Wall. 322; Van Brocklin *v.* Tennessee (1886) 117 U. S. 151; Home Savings Bank *v.* Des Moines (1907) 205 U. S. 503; Bank of California *v.* Richardson (1919) 248 U. S. 476.

was never regarded as a direct tax. Therefore a tax on the income from business was not within the proscription of the Pollock Case. The tax on income from business fell only because it was thought that Congress would not have taxed such income unless it were allowed to reach other income as well. The inference was that taxes on income from business would be sustained as indirect taxes whenever they were unmixed with other taxes thought direct.

In reliance on this inference Congress passed the Corporation Excise Tax of 1909. The subject selected for taxation was not income but carrying on business as a corporation. The measure of the annual demand on each corporation was its net income as computed under the provisions of the Act. In *Flint v. Stone Tracy Co.*,[8] decided in 1911, a unanimous Supreme Court held the tax an indirect one and permitted the assessment to include not only income directly from business but also income from municipal bonds and from other property not directly or actively used in the corporate business. We may criticise the legerdermain by which a few words in a statute turn a tax on income into a tax on something else merely measured by income; but we must believe in it as the gentleman believed in baptism, because he had seen it done. Mr. Justice Day assures us that the difference between the Income Tax of 1894 and the Corporation Excise Tax of 1909 "is not merely nominal, but rests upon substantial differences between the mere ownership of property and the actual doing of business in a certain way."[9] The tax directly on income from property has an "element of absolute and unavoidable demand"[10] which makes it a tax on property merely because of its ownership. In taxes on privileges the element of absolute and unavoidable demand is lacking. "If business is not done in the manner prescribed in the statute, no tax is payable."[11]

[8] (1911) 220 U. S. 107.

[9] *Ibid.*, 150.

[10] *Ibid.*, 151.

[11] *Ibid.* Thomas *v.* United States said of a tax on agreements to sell stock: "The stamp duty is contingent on the happening of the event of sale, and the element of absolute and unavoidable demand is lacking. As such it falls, as stamp taxes ordinarily do, within the second class of the forms of taxation." This second class is that of indirect taxes.

While the subject of the Corporation Excise Tax was referred to by the Court as a "privilege," it was in no sense a privilege granted by the federal government, and the tax was not therefore justified as a sort of a bonus. Other cases prior to the Sixteenth Amendment make clear that taxes on acts or occupations are excise taxes which may be levied by the United States without any apportionment among the states according to population. They make clear also that excises on acts and occupations may be measured in other ways than by net income. The cases that have sustained as indirect taxes the various excises on particular acts and particular occupations show that an excise on doing business in general would be an indirect tax. After the Pollock Case and before the Sixteenth Amendment a suggestion appeared that Congress impose an excise on doing business and measure its demand by the total income of each person subject to it, whether that income came directly from the business or from property unconnected with the business. Mr. Justice Day's opinion in the Stone-Tracy Case indicates that the Supreme Court might have winked at such a subterfuge. "The possession of large assets," he says, "is a business advantage of great value."[12] It gives standing and prestige, helps credit, and facilitates purchases. To him that hath shall be given. Such a tax would not have hit nonfeasant widows and orphans or any of the really idle rich. Doubtless the Court would have balked at recognizing coupon-clipping as itself a business, so there would have been some income that such a tax could not reach. This particular question has been deprived of practical importance by the Sixteenth Amendment. But the power of Congress apart from that Amendment deserves consideration for its revelation that assessments which might be defeated when laid formally on income may be victorious if levied in special acts or occupations or on doing business in general. The presence of this independent power shows the weakness of reliance on the Constitution when to a large extent the Constitution forbids, not the thing done, but only the particular way of doing it. An individual litigant may

[12] 220 U. S. 107, 166.

find it worth his while to escape from the toils of a statute even though it may readily be amended so that he is firmly held the following year. But such Pyrrhic victories are not very valuable to those who are thinking of what government may or may not do in the long run.

We turn, then, to the excise taxes which the federal government may levy without the aid of the Sixteenth Amendment. In 1869 Mr. Justice Swayne approved a definition of an excise which called it "an inland imposition, sometimes upon the consumption of a commodity, and sometimes on the retail sale; sometimes upon the manufacturer, and sometimes upon the vendor." [13] Between the Pollock Case and the Sixteenth Amendment, federal levies on the refining of sugar,[14] on the manufacture of colored oleomargarine[15] and of filled cheese,[16] on holding tobacco for sale,[17] on sales at exchanges,[18] on contracts to sell stock,[19] on the transmission of property by inheritance,[20] and on doing business as a corporation[21] were held to be excises. Before the Pollock Case, taxes on the insurance business,[22] on the issue of notes by a bank,[23] and on being prepared to distill spirits,[24] were held excises, and these decisions are unshaken by anything said or done since. Taxes on commercial instruments have been levied without number and never been questioned as not indirect taxes.[25] After the Sixteenth Amendment a tax on the use of foreign-built yachts by an American citizen was sustained as an excise.[26] These

[13] Pacific Insurance Co. *v.* Soule (1869) 7 Wall. 433, 445.

[14] Spreckels Sugar Refining Co. *v.* McClain (1904) 192 U. S. 397.

[15] McCray *v.* United States (1904) 195 U. S. 27.

[16] Cornell *v.* Coyne (1904) 192 U. S. 418.

[17] Patton *v.* Brady (1902) 184 U. S. 608.

[18] Nicol *v.* Ames (1899) 173 U. S. 509.

[19] Thomas *v.* United States (1904) 192 U. S. 363. This case refers to Treat *v.* White (1901) 181 U. S. 264, holding that a "call" for stock is an agreement to sell within the statute taxing such agreements.

[20] Knowlton *v.* Moore (1900) 178 U. S. 41.

[21] Flint *v.* Stone Tracy Co. (1911) 220 U. S. 107.

[22] Pacific Insurance Co. *v.* Soule (1869) 7 Wall. 433.

[23] Veazie Bank *v.* Fenno (1869) 8 Wall. 533.

[24] United States *v.* Singer (1872) 15 Wall. 111.

[25] For instances in which stamp taxes on commercial instruments have been held taxes on exports, see Fairbank *v.* United States (1901) 181 U. S. 283; United States *v.* Hvoslef (1915) 237 U. S. 1; Thames & Mersey M. Ins. Co. *v.* United States (1915) 237 U. S. 19.

[26] Billings *v.* United States (1914) 232 U. S. 261; United States *v.* Bennett (1914) 232 U. S. 299.

decisions carry us beyond the definition given by Mr. Justice Swayne in 1869. Excise taxes are not limited to those on the manufacture or sale of commodities. They include impositions on other acts and transfers. In 1911 Mr. Justice Day quoted with approval Chief Justice Fuller's earlier statement that the words "duties," "imposts," and "excises" are used in the Constitution "comprehensively to cover customs and excise duties imposed on importation, consumption, manufacture, and sale of certain commodities, privileges, particular business transactions, occupations, and the like."[27]

Up to this time the Supreme Court appears to have thought that no duty, impost, or excise could be a direct tax. For in this same opinion of 1911 Mr. Justice Day observes: "If we are correct in holding that this is an excise tax, there is nothing in the Constitution requiring such taxes to be apportioned according to population."[28] But after the Sixteenth Amendment the analysis was revamped a bit. In finding out what the Sixteenth Amendment meant to accomplish from the words "from whatever source derived," it was discovered that an income tax was always generically an indirect tax but that it sloughed off its generic character and became in substance a direct tax whenever it laid hold of income from property merely because of its ownership.[29] This is to say that an excise, though in form an indirect tax, may be in reality a direct tax whenever it is in substance a tax on property because of its ownership. This, however, is qualified by the Sixteenth Amendment which is construed to compel the Court to close its eyes to the substance of a tax on income and by disregarding the source of the income to leave the income tax in the class of indirect taxes where it always belonged generically.[30] No genuine income tax can any longer be held a direct tax. The only direct taxes are capitation taxes and taxes, other than income taxes, which are in substance taxes on property because

[27] Mr. Justice Day in Flint *v.* Stone Tracy Co. (1911) 220 U. S. 107, 151, quoting from Chief Justice Fuller in Thomas *v.* United States (1904) 192 U. S. 363, 370.

[28] 220 U. S. 107, 152.

[29] Chief Justice White, in Brushaber *v.* Union Pacific R. Co. (1916) 240 U. S. 1, 16–17.

[30] Chief Justice White, in Brushaber *v.* Union Pacific R. Co. (1916) 240 U. S. 1, 17–19, and Stanton *v.* Baltic Mining Co. (1916) 240 U. S. 103, 112–113; Mr. Justice Van Devanter, in Peck & Co. *v.* Lowe (1918) 247 U. S. 166, 172–173.

of its ownership. The Foreign-Built Yacht Cases [31] show that a tax on the use of property is not one on property because of its ownership. Other cases establish that taxes on the transfer of property are not taxes on the property because of its ownership.[32] Still others settle that taxes on acts or occupations are not taxes on property because measured by the value of property or by income from property.[33] As I did not invent these refinements, I am not concerned to defend them. Like Massachusetts, there they stand. For our purposes they are so because the Supreme Court says they are so. We are governed by them, however little we may love them.

If a tax on any particular act, business or occupation is an excise and an indirect tax, a tax on all acts, businesses and occupations must be an indirect tax. If indirect, it may be levied by the federal government without apportionment among the states according to population. It must not interfere with the instrumentalities of the states,[34] it must not reduce the compensation of the President or the federal judges,[35] it must not be a tax on exports,[36] and it must not offend the requirement of geographical uniformity.[37] But, aside from these restrictions, a federal tax on business may cut any of the capers that state excises may cut.[38] There is a hint that it may cut more. The Chief Justice seems to think that the Fifth Amendment does not limit the federal taxing power. He has the queer idea that the contrary notion would mean that the Constitution confers a power on the one hand

[31] Cases in note 26, *supra*.

[32] Cases in notes 17, 18, and 19, *supra*.

[33] Cases in notes 14, 18, 19, and 21, *supra*.

[34] See Pollock *v.* Farmers' Loan & Trust Co., note 7, *supra*, and Collector *v.* Day, and United States *v.* Railroad Co., note 7, *supra*.

[35] Evans *v.* Gore (1920) 253 U. S. 245.

[36] See cases in note 25, *supra*. But a tax on net income from an exporting business is not a tax on exports, Peck & Co. *v.* Lowe (1918) 247 U. S. 166.

[37] In Brushaber *v.* Union Pacific R. Co. (1916) 240 U. S. 1, 24, Chief Justice White refers to the cases establishing that the requirement that "all Duties, Imposts and Excises shall be uniform throughout the United States" exacts "only a geographical uniformity." See also his opinion in Billings *v.* United States (1914) 232 U. S. 261, 282.

[38] In Flint *v.* Stone Tracy Co. (1911) 220 U. S. 107, 153, Mr. Justice Day says: "In approaching this subject we must remember that enactments levying taxes, as other laws of the federal government when acting within its constitutional authority, are the supreme law of the land. The Constitution contains only two limitations on the right of Congress to levy excise taxes; they must be for the public welfare, and are required to be uniform

and takes it away on the other, and he reminds us that it is "settled that the Constitution is not self-destructive."[39] But there is no more incongruity in having the federal taxing power limited by the Fifth Amendment than in having state taxing power limited by the Fourteenth Amendment. The existence of power on the one hand and of constitutional restrictions on its exercise on the other is of the essence of our constitutional system. To borrow the simile of Mr. Ballantine,[40] a train is not self-destructive because it has both motive power and brakes. It may well be doubted whether the Supreme Court as a whole shares the strange theory of the Chief Justice.[41] Moreover, he leaves a loop-hole when he tells us that "this doctrine would have no application to a case where, although there was a seeming exercise of the taxing power, the act complained of was so arbitrary as to constrain to the con-

throughout the United States. As Mr. Chief Justice Chase said, speaking for the Court in License Tax Cases, 5 Wall. 462, 471: 'Congress cannot tax exports, and it must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity. Thus limited, and thus only, it reaches every subject, and may be exercised at discretion.' The limitations to which the Chief Justice refers were the only ones imposed in the Constitution upon the taxing power."

By construction the Constitution is discovered to forbid excises on state instrumentalities and excises which are thought to diminish the compensation of the President and of federal judges.

[39] "It is also settled beyond dispute that the Constitution is not self-destructive. In other words, that the powers which it confers on the one hand it does not immediately take away on the other; that is to say, that the authority to tax which is given in express terms is not limited or restricted by the subsequent provisions of the Constitution or the Amendments thereto, especially by the due-process clause of the Fifth Amendment." Chief Justice White in Billings *v.* United States (1914) 232 U. S. 261, 282.

[40] Arthur A. Ballantine, "Some Constitutional Aspects of the Excess Profits Tax," *Yale Law Journal*, vol. 29, p. 632.

[41] The idea, so far as I know, appears in the opinions of none of the Chief Justice's colleagues. Nor has the Chief Justice ever cited any one but himself in support of his declarations. In De Ganey *v.* Lederer (1919) 250 U. S. 376, the taxpayer contended that "the power of the United States to tax is limited to persons, property, and business within its jurisdiction, as much as that of the state is limited to the same subjects within its jurisdiction," citing United States *v.* Erie R. Co. (1882) 106 U. S. 327. The opinion of the Court dealt with the question chiefly as one of statutory construction, but pointed out that the states were allowed to tax property similarly situated. After referring to these cases, and saying that it would be "difficult to conceive how property could be more completely localized in the United States," Mr. Justice Day said: "There can be no question of the power of Congress to tax the income from such securities." Thus indirectly the power of Congress was supported by cases sustaining similar powers of the states, and there was no hint that Congress was immune from all constitutional restrictions.

In Hamilton *v.* Kentucky Distilleries & Warehouse Co. (1919) 251 U. S. 146, Mr. Justice Brandeis observed that "the war power of the United States, like its other powers and like the police powers of the States, is subject to applicable constitutional limitations."

clusion that it was not an exertion of taxation, but a confiscation of property."[42] This says that, though no federal tax, however vicious, can deny due process of law, a tax may be so bad as to be a tax in name only and therefore void because not within the power delegated to Congress. The difference between what the Chief Justice denies and what he grants, if any, is a difference only of degree. But we are assured that no federal excise will meet any greater obstacles than those which the Fourteenth Amendment plants in the way of the excises of the states.

We know that state excises may be measured in all sorts of odd ways. To quote from Judge Dillon:

> Business or occupation taxes *may be graduated in a great variety of ways*, as by the amount or value of the stock in trade of dealers, the marketable value of the product of factories, etc., or the quantity of goods manufactured or packed, the amount of sales or business transacted, the amount of receipts from the business, the gross earnings of the business, the number of persons employed in the business, the number of animals kept in connection with the business, and taxes so graduated are taxes on the occupation; and, although graduated according to the property used in the business or according to the business transacted, are not taxes upon property.[43]

The federal government has not exercised such variegated ingenuity in picking modes of assessment, but it has shown enough to leave little hope to those who would impose constitutional barriers against its fancy. None of its measures for assessing an excise has been declared unconstitutional. It has successfully applied its rates to the gross receipts from manufacture,[44] to the value of property sold,[45] or agreed to be sold,[46] to the face value of notes issued,[47] to the tonnage of yachts used,[48] to the weight of articles manufactured or held for sale,[49] and to the capacity to distill spirits whether the distillery is run to capacity or not.[50] Its specific taxes on

[42] 240 U. S. 1, 24–25.

[43] *Municipal Corporations*, Fifth Edition, section 1410, p. 2473.

[44] Spreckels Sugar Refining Co. *v.* McClain, note 14, *supra*.

[45] Nicol *v.* Ames, note 18, *supra*.

[46] Thomas *v.* United States, note 19, *supra*.

[47] Veazie Bank *v.* Fenno, note 23, *supra*.

[48] Billings *v.* United States and United States *v.* Bennett, note 26, *supra*.

[49] McCray *v.* United States, note 15, *supra*; Cornell *v.* Coyne, note 16, *supra*; Patton *v.* Brady, note 17, *supra*.

[50] United States *v.* Singer, note 24, *supra*.

acts or occupations appear not to have been questioned because of their measure. Its progressive rates on inheritances [51] and on incomes [52] have been sustained. My Brother Ballantine, who is a real dirt lawyer and not a genteel academic one and can therefore be trusted, assures us that the vagaries of the excess-profits tax are likely to run the gauntlet of the Supreme Court.[53] The excise on the manufacture of oleomargarine was conceded by demurrer to be big enough to destroy the industry.[54] We know that import duties are sometimes more than the traffic can bear. Of course Congress is not going to kill all the geese that lay the golden eggs. The ones it has already successfully picked for slaughter have been birds that could find no shelter under the conception of due process. Imports might be prohibited entirely.[55] The states were allowed to put oleomargarine under the ban by their police power.[56] If the tax on profits from child labor is sustained, it will not support similar destruction of more laudable enterprises that have due-process protection against state police measures. The Court may allow Congress to tax out of existence what it or the states might forbid directly, and yet still refuse to permit the strangling of enterprises that are without taint. Thus there still may be scope for the recognition that a tax is not a tax when it is confiscatory. But if business may be assessed by volume or by gross receipts, the Supreme Court's conception of income under any particular statute or under the Constitution is at best but a temporary shield against any taxes on business that Congress is determined to impose. An assessment that fails as one on income or one measured by income may succeed if changed to one on doing business and measured in the specific way that Congress directs. This is why I venture to call my subject a relatively unimportant one and to advise you to consider income taxation under canons of fairness, expediency and common sense,

[51] Knowlton *v.* Moore, note 20, *supra.*

[52] Brushaber *v.* Union Pacific R. Co. (1916) 240 U. S. 1.

[53] Note 40, *supra.*

[54] McCray *v.* United States, note 15, *supra.*

[55] Buttfield *v.* Stranahan (1904) 192 U. S. 470, *semble.*

[56] Powell *v.* Pennsylvania (1887) 127 U. S. 678.

and not to trouble much about the more majestic intricacies of constitutional law.

## II

Several instances have already appeared in which Congress has turned out to be less hard-hearted than an unclement Supreme Court. At various times the Court sustained Congress in assessing intercorporate dividends [57] and dividends from corporate assets accumulated prior to 1913,[58] in denying or limiting the deduction from gross receipts of the value of ore in place,[59] and in limiting the deduction of interest on indebtedness paid by corporations.[60] Of all these unkindnesses Congress has since repented. It has also changed the date from which corporate gains were reckoned, by making the Income Tax of 1913 a substitute for the Corporation Excise of 1909, thereby saving corporations from taxation on increments to capital developing between December 31, 1908, and March 1, 1913, but not realized until after the latter date. It is not certain that this latter act of mercy was intentional, since it required a decision of the Supreme Court to prevent the government from using the Act of 1913 to tax gains accruing before its effective date but realized thereafter.[61] But this decision did not prevent Congress from excluding corporations from the Act of 1913 and resubjecting them to the Act of 1909. Congress acquiesced when it did not have to. Moreover, its other ameliorations of the lot of taxpayers were entirely without any intervention by the Supreme Court. In at least four instances it abandoned allowable conceptions of legal income and went to a sounder basis of economic income.

The relief of intercorporate dividends may be disposed of briefly. The objection unsuccessfully urged against their inclusion in the Act of 1913 was not that they were not income,

[57] Brushaber *v.* Union Pacific R. Co., note 52, *supra*.

[58] Lynch *v.* Hornby (1918) 247 U. S. 339; Peabody *v.* Eisner (1918) 247 U. S. 347.

[59] Stratton's Independence *v.* Howbert (1913) 231 U. S. 399; Stanton *v.* Baltic Mining Co. (1916) 240 U. S. 103.

[60] Anderson *v.* Forty-two Broadway Co. (1915) 239 U. S. 69; Brushaber *v.* Union Pacific R. Co., note 52, *supra*.

[61] Lynch *v.* Turrish (1918) 247 U. S. 221.

but that it was an unwarranted discrimination to tax them when dividends received by individuals were exempt from the normal tax. The real objection to taxing them is of course that a corporation is nothing but a mechanism by which individuals do business and that its dividends are like checks drawn by an individual to himself. Corporate gains go ultimately to natural persons and any subtraction by taxation anywhere is a loss to the ultimate human recipient. Genuine economic income is not multiplied ten-fold by going through ten different conduits, for all the legal doctrine to the contrary. Congress now acts on this principle to the extent of excluding dividends received by corporations and sparing those received by individuals from the mild ravage of the normal tax.

Whether the limitation on the deduction of interest paid by a corporation goes to the question of what is income may occasion debate. In sanctioning the limitation in the 1909 Act the Supreme Court appeared to imply that it does, or at least that it goes to the question of what is net income. The first implication arises from Mr. Justice Pitney's reminder that "the Act of 1909 was not in any proper sense an income tax law, nor intended as such, but was an excise upon the conduct of business in a corporate capacity, the tax being measured by reference to the income in the manner prescribed by the Act itself."[62] The second implication springs from the declaration in the same opinion that it was error to seek "a theoretically accurate definition of 'net income', instead of adopting the meaning which is so clearly defined in the Act itself."[63] This seems to recognize pretty clearly that net income does not arise until the cost of the use of capital has been deducted. But this limitation on the deduction of interest paid was incorporated in the Act of 1913 and was sustained in the Brushaber Case.[64] The objection urged against it appears to have been only that the disallowance was discriminatory between different corporations and between corporations and

[62] Anderson *v.* Forty-two Broadway Co. (1915) 239 U. S. 69, 72.

[63] *Ibid.*

[64] Note 52, *supra.*

individuals. The decision sanctioning the provision complained of is open to several interpretations. Technically it can mean only that the disallowance is not constitutionally vicious because not visited on everyone. Yet it is natural to infer that it means more. The absence of any *caveat* or qualification in the opinion of the Chief Justice inclines us to think that he does not regard a disallowance of deduction of interest as an offence against the Sixteenth Amendment. This would mean that it does not go to the question of gross income and that the Amendment is not restricted to net income. Yet it would be possible to insist that the case involved only the income of a corporation, that power to tax this income is not dependent upon the Sixteenth Amendment and that it may therefore be urged that in reckoning the income from property of one not engaged in business the Amendment requires a deduction of interest paid on capital borrowed to acquire the property. My guess is, however, that no contention as to interest will find any other ground to stand on than that of statutory interpretation. This is reinforced by the complete latitude allowed the states in deciding what debts shall be deducted in assessing the general property tax.

The taxation of corporate dividends illustrates forcibly the distinction between legal income and genuine economic income. These may be taxed under the Sixteenth Amendment without regard to the question whether they represent any actual gain to the recipient. In *Lynch v. Hornby*,[65] Hornby who had owned some stock from 1906 to 1915 was taxed on some $17,000 paid him after 1913 from corporate accumulations prior to 1913. In economics this was nothing but a change in the form of values which Hornby possessed before the Sixteenth Amendment was in force. A similar catastrophe took place in *Peabody v. Eisner*,[66] where Peabody had to pay a 1914 tax on the value of some Baltimore and Ohio stock turned over to him by the Union Pacific. He was not a bit richer from the transaction than he had been before 1913 when the U. P. owned the B. & O. and he owned his U. P. on which the B. & O. was

[65] Note 58, *supra*.
[66] Note 58, *supra*.

later paid him as a dividend. Mr. Justice Pitney recognized in the Hornby Case that the dividend "might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing"[67] and that "every dividend distribution diminished by so much the assets of the corporation and in a theoretical sense reduced the intrinsic value of the stock."[68] Yet he says that the Sixteenth Amendment allows Congress to treat the dividends as coming to the stockholder "*ab extra* and as constituting part of his income when they come to hand."[69] Since no account is taken of the circumstances under which the stockholder acquired his interest in the corporation, he may be taxed on melons cut the day after he bought his stock at a price based on the general knowledge that the melon was there and the knife was already raised to slice it.

The only good reason for this must be that practical convenience may be thought to demand that the corporation and the stockholder be treated as altogether distinct. The reasons which Mr. Justice Pitney ventures are bad reasons. He says that dividends are usually reckoned by the recipient as income and expended as such without regard to whether they are the fruit of accumulated corporate surplus, and that dividends, though they theoretically reduce the intrinsic value of the stock, demonstrate the capacity of the corporation to pay them and quite probably increase the market value of the shares. This has a goodly measure of truth when applied to ordinary recurring dividends but it is palpably inapplicable to others. One who desires to keep his capital intact does not regard extraordinary cash dividends as income to be spent as such, except to the extent that they represent a gain on his original investment. This lesson is one that I had the misfortune to learn from experience. After managing for others some investments in farm mortgages for a number of years, I found the principal reduced by several hundred dollars.

[67] 247 U. S. 339, 344.
[68] *Ibid.*, 346.
[69] *Ibid.*, 344.

With the aid of an accountant I discovered that I kept small payments on principal in the bank account, that from this I paid in advance the accrued interest on new loans purchased, and then when twelve months interest came in I generously distributed it all among the beneficiaries. Mr. Justice Pitney would make a similar mistake if as agent or trustee he should buy some stock at a price which includes the value of an undistributed corporate surplus and then should later divide among the beneficiaries an extraordinary cash dividend which that corporate surplus alone made possible. Congress has now withheld its hands from dividends from corporate surplus accumulated prior to 1913. But this is of decreasing importance year by year and it does not save a stockholder from being taxed on dividends which are not genuine gain to his capital.

The disallowance of depletion of mines also goes to the question of what is really income. A miner without a mine to mine could produce no income from mining. If he buys a ton of ore in place and then sells it to another while still in place, his income from the transaction would at least be limited to the excess of what he got over what he paid. If instead of selling it in place, he extracts it and sells it, his gain in this case, as in the other, cannot equal all that he gets. If he spends all that he gets, his capital is reduced by the amount that he paid for the ore in place. The situation is not different if he buys a million tons in place and extracts and sells it a ton at a time. Yet the Corporation Excise of 1909, which professed to be measured by income, overlooked these patent considerations and allowed mining corporations no deduction for the value in place of the ore extracted. The complaining corporation in *Stratton's Independence v. Howbert* [70] was not unduly modest in its demand for a deduction. It insisted that the value of the ore in place was to be found by subtracting the expenses of mining it from the sum for which it was sold. Its theory appeared to be that the whole operation was a profitless conversion of capital assets from one form into another. Confining its decision to the rejection of this theory, the

[70] Note 59, *supra*.

Supreme Court denied the claim to a deduction. The Chief Justice and Justices McKenna and Holmes dissented; but three years later they joined with their colleagues in *Von Baumbach v. Sargent Land Co.*[71] in holding that no deduction for depletion was required. The lessor of a mine was assessed on the royalties received, and the partial exhaustion of the mine due to the extraction of the ore by the lessee was held not to be "depreciation" as the term was used by Congress.

The issue in these two cases appears to be solely one of statutory construction. From available abstracts of the briefs it does not appear that the companies adduced any constitutional complaint. The Court does not discuss any constitutional question. In the first case, however, Mr. Justice Pitney observed that what should be deemed income within the Act need not be confined to what would be taxable as income. So the case could not rightly be regarded as authority for a definition of income under the Sixteenth Amendment. Nevertheless the Supreme Court in *Stanton v. Baltic Mining Co.*[72] allowed Congress to limit the allowance for depletion in assessing the Income Tax of 1913, and apparently dismissed as immaterial the contention that allowance must be made for restoration of capital before receipts can be taxed as income. It cannot be said dogmatically that the contention was dismissed, for the Chief Justice seems first to have warped it and then to have dismissed it in its warped form. Mr. Snow for the appellant argued that "nothing can be income unless it represents a gain or profit." "If it represents a loss of capital assets," he says, "that must first be restored or allowed for, before any income can result." Mr. Van Derlip as *amicus curiae* contended that "things which are not in fact income cannot be made such by mere legislative fiat" and that "only so much of the receipts or royalties (as the case may be) as are in excess of the capital investment included in them is income that can be considered in assessing an income tax." This seems a clear contention that inadequate allowance for depletion makes the tax *pro tanto* one on

[71] (1917) 242 U. S. 503.
[72] (1916) 240 U. S. 103, note 59, *supra*.

capital and therefore not within the Sixteenth Amendment. But the Chief Justice treats it as a contention that, because of the peculiar source of income from mining, a tax thereon is on property because of its ownership, thus assuming it to be conceded that the assessment was on income. To this he answers that the Sixteenth Amendment conferred no new power of taxation but simply forbade looking at the source of income to determine whether a tax in form indirect is in substance direct. He clinches the matter by saying that the contention "asserts a right to take the taxation of mining corporations out of the rule established by the Sixteenth Amendment when there is no authority for so doing." [73]

This, however, is but one ground of the decision. The other is more important. It is that the tax complained of does not need the aid of the Sixteenth Amendment. The Chief Justice tells us that the idea that inadequate allowance for exhaustion makes the tax one on property because of its ownership rests upon a "wholly fallacious assumption because, independently of the effect of the operation of the Sixteenth Amendment, it was settled in *Stratton's Independence v. Howbert*, 231 U. S. 399, that such tax is not upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations." [74] This, however, was settled in a case in which it was declared that what Congress means by income need not be confined to what is really income. In the Act of 1913 and its successors Congress professes to be taxing income as such. But the Court says in effect that it does not matter whether what Congress calls income is really income if it is the proceeds from business which are the proper subject of an indirect tax without any help from the Sixteenth Amendment. It seems, then, that corporations have no more constitutional protection against the Act of 1913 than they have against the Act of 1909. If this idea is carried to its full extent, it applies to any tax on those engaged in business, since Congress has no more or no different power over doing business in corporate form than over doing business in other forms.

[73] 240 U. S. 103, 113.
[74] *Ibid.*, 114.

We see what a wide door this opens when we recall that in assessing the Corporation Excise, Congress was allowed a free hand in including income from state securities and from property not actively employed in the business, and in excluding deduction for interest paid out.

I do not venture to prophesy that the Court will go as far as it has pointed the way. The pointer consists of logical implications, and courts often refuse to follow logical implications. Nevertheless it is well to bear in mind the possibility that the Supreme Court will sanction exactions under an income tax that it would permit under a business tax. So long as the rose is really the same rose, it may smell as sweet by any other name. Yet whether this turns out to be so or not, Congress may escape from temporary barriers by picking the right name. I see no permanent constitutional protection against any taxes on business that Congress is determined to impose. I do see, however, a willingness on the part of Congress to accept fairer and fairer definitions of income. In the matter of allowance for mine depletion Congress has relented still further than in the Act of 1913. In 1916 it abandoned the five per cent. limitation on the allowance and provided for a reasonable allowance "not to exceed the market value in the mine of the product thereof which has been mined and sold during the year." [75] The 1918 law sweeps away even this restriction.[76] It seems not too much to hope that the time will come when other inequities of our federal taxing system will be abolished and when all we shall have to quarrel with will be the rates.

## III

In so far as the power of Congress to levy an unapportioned tax depends upon the Sixteenth Amendment, it can assess only what the Supreme Court regards as income, or at most what it thinks may reasonably be regarded as income. Whether the test is the former or the latter will depend upon the composition of the bench. The word proved to be a crystal

[75] *Cf.* Von Baumbach *v.* Sargent Land Co. (1917) 242 U. S. 503, 525.
[76] Sec. 214 (a) (10).

after all, but only by a five-to-four vote. Minorities become majorities on the Supreme Court as elsewhere. But taking *Eisner v. Macomber*[77] as a datum, the Constitution still offers hope to those who are not engaged in business. Yet the case proceeded on a ground so narrow that the hope must be a limited one. Stock dividends were held not income because they were thought to involve neither payment nor receipt. They were but a new index of an unrealized appreciation of capital. To get income from property there must be something extracted therefrom. One does not get income merely by growing richer. To have income, something really new must come in. It can't come in to one person except as it comes out from some one else. A scrap of paper will not necessarily do. A corporation that issues a stock dividend does no more than a man who gives his note. This is all that the Stock Dividend Case held. It did not go on the ground that the stock dividend does not bring a gain to the recipient. This ground was not available after extraordinary cash dividends and dividends in property had been held income whether they brought gain or not, and proceeds from ore had been held income without allowing for depletion. If we were to seek the Supreme Court's conception of the meaning of income in the Sixteenth Amendment from the cases in which the Amendment has been interpreted, we should say that segregation or receipt is a *sine qua non* of income, but that gain is not. We should say also that anything received within a given year may be treated as income for that year, even though it is the cashing in of gains long past. But corporate dividends and mine depletion present peculiar problems, and the cases that have disregarded the absence or the antiquity

[77] (1920) 252 U. S. 189. For discussions of this decision, see Charles E. Clark, "Eisner *v.* Macomber and Some Income Tax Problems," *Yale L. J.*, vol. 29, p. 735; Fred R. Fairchild, "The Stock Dividend Decision," *Bull. Nat. Tax. Ass'n.*, vol. 5, p. 208; Thomas Reed Powell, "The Stock Dividend Decision and the Corporate Nonentity," *Bull. Nat. Tax. Ass'n.*, vol. 5, p. 201, "The Judicial Debate on the Taxability of Stock Dividends as Income," *Bull. Nat. Tax. Ass'n.*, vol. 5, p. 247, "Stock Dividends, Direct Taxes, and the Sixteenth Amendment," *Colum. L.*, Rev., vol. 20, p. 536; A. M. Sakolski, "Accounting Features of the Stock Dividend Decision," *Bull. Nat. Tax Ass'n.*, vol. 5, p. 212; Edward H. Warren, "Taxability of Stock Dividends as Income," *Harv. L. Rev.*, vol. 33, p. 885; and editorial notes in *Mich. L. Rev.*, vol. 18, p. 689; *Minn. L. Rev.*, vol. 4, p. 462; *U. Pa. L. Rev.*, vol. 68, p. 394; and *Yale L. J.*, vol. 29, p. 812.

of gain in finding income under the Sixteenth Amendment may not set the style for cases where no peculiarities are discovered.

Owing to these oddities in the mine depletion and dividend cases, and to the fact that the Stock Dividend Case is the only one declaring unconstitutional any assessment under the Act of 1909 or the Act of 1913 and its progeny, we must get our light on the Supreme Court's conceptions of income chiefly from cases on questions of statutory construction. We cannot be certain what these cases mean from the standpoint of constitutional law. We cannot be sure that what Congress was allowed to call income under the Act of 1909 it may call income under the Sixteenth Amendment. It was clearly laid down that an excise on doing business in a corporate capacity may be measured by something not directly taxable as income. While the *caveat* was not taken advantage of in the Mine Depletion Case under the Act of 1913,[78] this does not preclude it from playing a part in other situations. There is a bare possibility, too, that something held income under an Income Tax Act, where no constitutional objection was adduced, might be held not income under the Sixteenth Amendment. Of course anything accepted as income under the statute where the draughtsmen left the court free to adopt any conception that it chose would be accepted as income under the Amendment. But explicit directions in an income tax law might be applied as the statutory definition of income, and that definition later held to transcend the meaning of income in the Amendment. According to accepted canons, the Supreme Court does not pass on constitutional issues unless they are clearly raised. A still further difficulty in seeking constitutional law from decisions on statutory interpretation is that we cannot be confident that something excluded from the meaning of income in a statute will be held not income under the Sixteenth Amendment. In the first Stock Dividend Case eight judges allowed the impression to go forth that income may have a more inclusive meaning in the Constitution than elsewhere.[79] Though the distinction there acknowl-

[78] Stanton *v.* Baltic Mining Co., note 59, *supra.*

[79] In Towne *v.* Eisner (1918) 245 U. S. 418, 425, Mr. Justice Holmes, in pointing out that the decision that stock dividends were not included in the word "income" as used in the

edged did not find recognition in the second Stock Dividend Case,[80] it is still possible that in future cases five judges instead of four will hold it applicable. It is a well-recognized canon of statutory construction that the Court will lean to a construction that avoids raising doubtful constitutional questions. It is a professed canon of constitutional interpretation that great weight will be attached to the judgment of the legislature and that it will be given the benefit of every doubt. Both these canons are honored in the breach as well as in the observance, but it still remains true that by and large the courts are much more loath to reject plain words in a statute than to restrict vague words to the meaning they think most appropriate.

Turning, then, to the cases on statutory construction we find five, all argued on March 4, 5, and 6, 1918, together with the dividend cases of *Lynch v. Hornby* [81] and *Peabody v. Eisner*.[82] The three cases under the Act of 1909,[83] decided together on May 20, 1918, had to do with profits from the sale of corporate stock and of lumber. In each case the gain realized by the sale had accrued partly before January 1, 1909, the effective date of the Act, and partly subsequent thereto. In each case the court held that the gain accrued after the effective date of the Act was taxable income and that the gain accrued prior was not. Mr. Justice Pitney said that the effort of the government to reach the gain accrued prior to the effective date of the Act "finds no support in either the letter or the spirit of the Act, and brings the former into incongruity with the latter." [84] Treasury Regulations were adduced to show that the Treasury regarded the statute as

Act of 1913 did not involve the conclusion that they could not be regarded as income under the Sixteenth Amendment, declared: "But it is not necessarily true that income means the same thing in the Constitution and the act. A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." The decision was unanimous, but Mr. Justice McKenna confined his concurrence to the result.

[80] Eisner *v.* Macomber, note 76, *supra*.

[81] Note 58, *supra*.

[82] Note 58, *supra*.

[83] Doyle *v.* Mitchell Brothers Co. (1918) 247 U. S. 179; Hays *v.* Gauley Mountain Coal Co. (1918) 247 U. S. 189; United States *v.* Cleveland, C. C. & St. L. R. Co. (1918) 247 U. S. 195.

[84] 247 U. S. 179, 184.

one seeking to reach only gain arising after its effective date. These were thought to represent the proper interpretation of the Act in respect to profit from the sale of lumber or corporate stock as well as in respect to general manufacturing and mercantile transactions. The Mine Depletion Cases were dismissed as presenting only a superficial analogy to proceeds from the sale of timber, since, "owing to the peculiar nature of mining property, its partial exhaustion attributable to the removal of ores, cannot be regarded as depreciation within the meaning of the Act." [85] In confining the Act to gains arising after its effective date, Mr. Justice Pitney said:

> When the Act took effect, plaintiff's timber lands, with whatever value they then possessed, were part of its capital assets, and a subsequent change of form, by conversion into money, did not change the essence. Their increased value since purchase, as that value stood on December 31, 1908, was not in any proper sense the result of the operation and management of the business or property of the corporation while the Act was in force.[86]

So far as appears, the decision on this point was founded solely on the assumed self-restraint of Congress. There is no direct suggestion that the tax could not constitutionally have been measured by the total gain represented in the proceeds of the property sold. The fact that at a given moment the property is all capital does not prevent some of it from becoming income upon a sale, as is shown by the decision that the gain arising after 1908 is taxable. January 1, 1909, and March 1, 1913, mean no more to the economist than any other dates. That gains accrued prior to the enactment of a law but realized subsequent thereto may be income under the statute and the Sixteenth Amendment is clear from the Mine Depletion and Extraordinary Dividend Cases. That a tax statute may be retroactive both as to gains and their realization has been explicitly adjudicated.[87] That the Court will construe tax statutes to be prospective only, unless there are clear words to the contrary, is established. So it is quite likely that the datum line which the Court has taken in reckon-

[85] *Ibid.*, 188.

[86] *Ibid.*, 187.

[87] Stockdale *v.* Atlantic Insurance Co. (1874) 20 Wall. 323; Brushaber *v.* Union Pacific R. Co., note 52, *supra.*

ing gains is due wholly to an attitude towards the statute and not to an attitude towards the Constitution. So far as accrued gains prior to March 1, 1913, are concerned, we may put the question to one side. For Congress has accepted the conclusion of the Supreme Court that in its income tax laws as well as in its Corporation Excise Act it did not mean to tax gains from sale of property except to the extent that the gain was subsequent to 1908 or to February 28, 1913, as the case may be. In addition Congress has graciously withdrawn its hand from prior gains got in by way of corporate dividends and by way of the extraction and sale of ore. The possibility of a reversal of this policy is a slim one and is of decreasing importance as 1913 recedes farther and farther into the past. However, there still remains for explicit adjudication the issue whether gains in the value of property from March 1, 1913, but prior to the year in which they are realized by sale, may be treated as technical income under the Sixteenth Amendment. That such gains are not income prior to their realization seems to be settled by Mr. Justice Pitney's discussion in the Second Stock Dividend Case. That they will be held income when realized is to be anticipated.

The theoretical objections to such a result were met and overcome in the cases under the Act of 1909. In *Doyle v. Mitchell Brothers Co.*,[88] the efforts of counsel for the taxpayer were directed primarily to the exclusion of gains prior to the Act. In this they were successful. The timber lands from which the lumber was derived had not enhanced in value since the Act. The suit to recover back the tax paid asked only for an allowance of the difference between the stumpage value when the lands were purchased and the increased value on December 31, 1908. The Court, therefore, was not called upon to consider the question of enhancement since that date. Yet it appears to have been argued that, since the stumpage value at the beginning of 1909 and at the date of cutting was the same, "the entire proceeds of the conversion should be still treated as the same capital, changed only in form, and containing no element of income although

[88] Note 82, *supra*.

including an increment of value."[89] This was dismissed with the remark that "selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received 'from all sources'."[90] The gains thus taxed were profits from the process of turning trees into boards. The case did not involve the ordinary enhancement of property realized only by sale. Yet Mr. Justice Pitney is evidently thinking of such a situation when he says:

> "Income may be defined as the gain derived from capital, from labor, or from both combined."
>
> Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the "gross income" received "from all sources;" and by applying to this the authorized deductions we arrive at "net income." In order to determine whether there has been a gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.[91]

The period under consideration was the period since the effective date of the statute.

While Mr. Justice Pitney's essay was dictum in the particular opinion which contained it, it was not dictum when applied, as it was, to the other two cases decided the same day. *Hays v. Gauley Mountain Coal Co.*[92] involved corporate stock bought in 1902 and sold in 1911. The taxpayer cited *Gray v. Darlington*[93] for the contention that "the increase over its original cost in the value of an investment held during a long term of years by a non-trader does not constitute income for the year when the investment is finally sold and the increase in value turned into cash." *Gray v. Darlington* had held that a profit on the sale in 1869 of bonds bought in 1865 was none of it income for the year 1869 under the Income Tax Act of 1867,

[89] 247 U. S. 179, 183.
[90] *Ibid.*
[91] *Ibid.*, 185.
[92] Note 82, *supra.*
[93] (1872) 15 Wall. 63.

since the Act of 1867 "looks, with some exceptions, for subjects of taxation only to annual gains, profits and income." [94] One of the exceptions noted is in the case of sales of real estate when the profits of the sale are taxed "where the property has been purchased, not only within the preceding year, but within the two previous years." [95] This was long before the Pollock Case and the Sixteenth Amendment, and the decision was based wholly on the intention of Congress. In the Gauley Mountain Case Mr. Justice Pitney dismisses the Darlington Case by saying that "gains, profits and income *for* the year" in the Act of 1867 "conveys a different meaning from 'the entire net income . . . *received by it during* such year'." [96] The latter was said to look "to the time of realization rather than to the period of accruement, except as the taking effect of the Act on a specified date (January 1, 1909) excludes income that accrued before that date." [97] After holding that interest could not be added to the purchase price to ascertain the cost of the property, Mr. Justice Pitney concluded:

> It results that so much of the $210,000 of profits as may be deemed to have accrued subsequent to December 31, 1908, must be treated as part of the "gross income" of respondent. For it is the simple case of a conversion of capital assets acquired before and turned into money after the taking effect of the Act; and, as we have shown in *Doyle v. Mitchell Brothers Co.*, this day decided, since a conversion of capital often results in gain, the general purpose of the Act of 1909 to measure the tax by the increase arising from corporate activities, together with income from invested property, leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the Act must be regarded as "gross income;" and to this end it must be distinguished from that portion which represents a return of the capital value existing before.[98]

Mr. Justice Pitney plainly thinks that realized gain from the sale of property is income. He appears to think that the gain may be income for the year in which the property is sold, no matter how long it has been in accruing. For he says that the Act of 1909 "measured the tax by the income received within

[94] 15 Wall, 63, 65.
[95] *Ibid.*, 66.
[96] 247 U. S. 189, 192.
[97] *Ibid.*
[98] *Ibid.*, 193.

the year for which the assessment was levied, whether it accrued within that year or in some preceding year while the Act was in effect; but it excluded all income that accrued prior to January 1, 1909, although afterwards received while the Act was in effect."[99] The learned Justice's locution might be improved if he avoided speaking of "income accrued" and "income received." He seems to jumble Professor Haig's economic income with the Supreme Court's legal income. According to the Court, gain is not income until realized. The Court would do better to stick to its legal conception and use the word "gain" rather than "income" when it is speaking of the period of accrual prior to realization. It may be kind of the judges to lend aid to Professor Haig by their words when their deeds sustain Professor Seligman, but the kindness is apt to cause confusion.

In guessing how much weight this interpretation of income in the Act of 1909 should have in forecasting the interpretation of income under the Sixteenth Amendment, note should be taken of the fact that the court had it specifically called to its attention that the gain in the Gauley Mountain Case was by a non-trader. And Mr. Justice Pitney remarks that "the business of trading in stocks is not included among its corporate powers, nor does it appear that, with a single exception, it ever bought or sold any."[100] So in *United States v. Cleveland, C.C. & St. L. R. Co.*,[101] decided the same day, he refers to the fact that "the assets here under consideration were not acquired for the purpose of sale in the manner of merchandise, but were bought for investment."[102] On the other hand, the government in its brief argued that the case of assets acquired for a purpose incidental to a general business and sold when no longer needed is different from that of investments unconnected with any business, and that if *Gray v. Darlington*[103] be taken to lay down a rule that a conversion of capital does not produce income at all, and if that rule be considered sound by the Court,

[99] *Ibid.*, 192.
[100] *Ibid.*, 190.
[101] Note 82, *supra*.
[102] 247 U. S. 195, 196.
[103] Note 92, *supra*.

it does not apply to capital incidentally connected with a business. Though this contention was not mentioned in the opinion of the Court, the fact that it was made and that it covered not only the case at bar but the other cases decided at the same time furnishes a leverage for those who wish to contend that a distinction may be drawn between sales of capital by persons not in business at all and sales of capital by persons in business even though the business is not the buying and selling of the sort of capital in question. Any decision under the Corporation Excise Tax Act is subject to restrictions because of the recognition that the measure of that tax need not be income that would be taxable as such. So there is a technical crack to serve as an opening for those who contend that realized gains from sale of capital unconnected with any business are not income under the Sixteenth Amendment.

This technical crack is not closed by either of the two decisions under the Act of 1913. Both cases involved somewhat peculiar situations. In *Lynch v. Turrish* [104] a corporation went out of business and distributed its entire assets among its stockholders. In *Southern Pacific Co. v. Lowe*,[105] the Southern Pacific, which owned all the stock of the Central Pacific, of whose road it was the lessee and of which it was formally a debtor, got its debt cancelled through a book-keeping arrangement by which the Central Pacific went through the motions of reducing its surplus by declaring a dividend. Neither of these transactions symbolized any gain that had accrued since March 1, 1913. Both were held not to yield any income within the meaning of the Act of 1913. The interrelation between the Union Pacific and the Central Pacific and the fact that the former had for some time had the funds represented by the formal dividend were held to take the transaction out of the rule of ordinary dividends. So the Court was free to see whether the formal transaction related to a gain since the effective date of the Act. In denying the contention of the Government that the entire yield of a conversion of capital is income, Mr. Justice Pitney says that the term "income" certainly has no

[104] Note 61, *supra*.
[105] (1918) 247 U. S. 330.

broader meaning in the Act of 1913 than in that of 1909 "and for the present purpose we assume that there is no difference in its meaning as used in the two acts." [106] "This being so," he adds, "we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purposes of the Act." [107] Later he is careful to say that the case turns on its very peculiar facts and that under the circumstances "so far as the dividends represented the surplus of the Central Pacific that accumulated prior to January 1, 1913, they were not taxable within the true intent and meaning of the Act of 1913." [108] This invites the inference that the Act of 1913 like that of 1909 would reach realized gain from sale of capital assets to the extent that the gain accrued after its effective date. But here, as in the cases under the Act of 1909, the taxpayer was engaged in business and the capital in question had some relation to the business.

The opinion in *Lynch v. Turrish* [109] was written by Mr. Justice McKenna. He said all that was called for when he declared that "if increase in value of the lands was income, it had its particular time, and such time must have been within the time of the law to be subject to the law; that is, it must have been after March 1, 1913." [110] Since there was no increase in value after that date, the case called for no comment on the question whether increase after March 1, 1913, might be taxed as income when realized. But in answering the contention of the government that all the gain realized by the sale is income and that *Gray v. Darlington* [111] is inapplicable because "the Act of 1913 makes the income taxed one 'arising or accruing' in the preceding calendar year, while the Act of 1867 makes the income one 'derived'," [112] Mr. Justice McKenna observes:

> Granted that there is a shade of difference between the words, it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the

[106] *Ibid.*, 335.
[107] *Ibid.*
[108] *Ibid.*, 338.
[109] Note 61, *supra*.
[110] 247 U. S. 221, 229.
[111] Note 92, *supra*.
[112] 247 U. S. 221, 230.

disputes of purists. Besides, the contention of the government does not reach the principle of *Gray v. Darlington*, which is that the gradual advance in the value of property during a series of years can in no just sense be ascribed to a particular year, not therefore as "arising or accruing," to meet the challenge of the words, in the last one of the years, as the government contends, and taxable as income for that year or when turned into cash. Indeed, the case decides that such advance in value is not income at all, but merely increase of capital, and not subject to a tax as income.[113]

This seems to make no distinction between gain growing after the statute and that growing before. Yet it is directed to the support of a proposition announced by the Circuit Judge that the enhancement in the value of timber lands during a series of years "prior to the effective date of an income tax law, although divided or distributed by dividend or otherwise subsequent to that date, does not become income, gains or profits taxable under such an act." [114] When we turn to *Gray v. Darlington*, which Mr. Justice McKenna says has not been questioned or modified, we find it based wholly on interpretation of a statute that was said to look with some exceptions only to annual gains, profits and income. In that case Mr. Justice Field said that "mere advance" in value is not income but capital. He did not say that income could not arise when the "mere advance" becomes a realized advance. He did say that it could not in any just sense be income for the particular year of realization. However, the case under the Act of 1909 holds that it may be assessed as income derived in that year in a tax on doing business as a corporation. To that extent the case of *Gray v. Darlington* was modified. Moreover, Mr. Justice Pitney leads us to believe that he thinks the Acts of 1909 and of 1913 alike in their intention both to exclude gain accrued prior to their passage and to include gain accrued since and realized by the requisite conversion.

Mr. Justice Pitney goes still further in *Eisner v. Macomber* [115] and adopts the definition of income under the Act of 1909 as the definition under the Sixteenth Amendment. After empha-

[113] 247 U. S. 221, 230–231.
[114] *Ibid.*, 226.
[115] Note 76, *supra*.

sizing the duty of the court in applying the Amendment to distinguish between what is income and what is not, and saying that "for the present purpose we require only a clear definition of the term 'income', as used in common speech, in order to determine its meaning in the Amendment," [116] he continues:

> After examining dictionaries in common use . . . , we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of August 5, 1909 . . . : "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a conversion of capital assets, to which it was applied in the Doyle Case.[117]

And later in the same opinion he says:

> It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in so doing realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit.[118]

Plainly Mr. Justice Pitney thinks that gain produced by the sale of capital is income. His insistence in the Stock Dividend Case is that this gain to be income must proceed from, be severed from, be derived from the capital, be received or drawn by the recipient, and that it is not enough to have it accrue to the capital or to be merely "a *growth* or *increment* of value *in* the investment." [119] But extract the gain from capital and it is income; in so far as the income represents a gain since the Sixteenth Amendment, it is taxable under the Amendment.

If Mr. Justice McKenna really objects to this, it is strange that he concurred in all of Mr. Justice Pitney's opinions as well as in his decisions. The latter specifically linked his definitions to the meaning of income in the Sixteenth Amendment. He was talking of a situation in which the taxpayer is not engaged in business. His statement was dictum but it was important dictum because it was designed specifically to allay apprehension that the decision that stock dividends are

[116] 252 U. S. 189, 206–207.
[117] *Ibid.*, 207.
[118] *Ibid.*, 212.
[119] *Ibid.*, 207.

not income cuts the government off forever from any tax on the gains transmitted in that way. Mr. Justice McKenna's statements in *Lynch v. Turrish*[120] were also dicta. And whatever Mr. Justice McKenna may think, he is only one member of the Court. Mr. Justice Pitney is fully persuaded that a profit from the sale of capital is income, and that so much of it as arose since the Sixteenth Amendment is taxable as such. The four dissenting justices in the Stock Dividend Case who approve of a latitudinarian interpretation of "income" as used in the Amendment will certainly make it include profits from the sale of capital, since they made it include a shift in the evidence of capital and did not care whether it represented profits or not. We may be sure, therefore, that a majority of the Supreme Court as now constituted are of opinion that gain from the sale of capital assets is taxable as income to the extent that the gain arose since the Sixteenth Amendment became part of the law of the land.

There may be those who find it hard to believe that values which are wholly capital so long as they inhere in some particular stock or bond or acre of land can become part capital and part income by extraction from that in which they heretofore inhered. This, however, is only because the result may offend categories which they choose to set up. Such categories may be useful for the particular purpose for which they are invented and still not be sanctified by the Constitution of the United States. If the growing value of a share of corporate stock remains capital so long as the company keeps hold of what gives that stock value, but becomes income the moment the company empties the value from its surplus and pours it out in extraordinary cash dividends, a similar metamorphosis may as readily be discovered when the stockholder by sale turns his stock into cash. "Realized gain" is a pretty sensible definition of income for a practical man, however it may seem to an expert conceptualist. To say that it cannot be income because the gain and its realization are not wholly synchronous is to forget that realization is almost always instantaneous while gain is usually gradual. A lawyer does not get his fee

[120] Note 61, *supra*.

second by second as he earns it, nor a singer note by note as he sings his song. A gardener hoes and weeds for some time before he takes his peas and beans to market. So if he lets time and neighbors do his gardening for him, and watches his land grow values instead of crops, he sees his gain growing before it is ripe enough to pick. The economics of an objection to finding income in the profit on a sale of capital would apply to practically everything else held to be income. Practical fiscal necessity demands its rejection. Taxes are recurrent and each tax has to be for a period of time. An income tax lives only on change. In the case of corporate dividends it may feed on change in form even though there may be no change in value. In other cases change in value and change in form are both required. These changes seldom occur wholly in unison, and often one takes place in one tax period and one in another. Gain grows while the grocer or doctor or lawyer extends credit to a solvent patron. The overflow from the reservoir gets into the pipes before the tap is opened. There would be little income from any source if preliminary storage of the yield of labor or capital could not be counted.

This is not to say that the time required for this preliminary storage is not important. When the pipes fill slowly and the tap can be opened but seldom, the sensible man does not consume as fast as he can draw. He will not regard a week's gain as a day's income, nor a ten years' gain as a one year's income. Mr. Justice Field is quite right when he says that an advance in value over a series of years cannot in any just sense be considered the income of any one particular year in which the advance is turned into money. From the standpoint of income taxation the question of justice would hardly arise if no greater tax were laid on ten years' gain realized in a lump than on the same gain realized evenly year by year. But our progressive rates of assessment varying with the amount realized in any given twelve months penalizes severely the lumping of realization. Whether such penalizing is justifiable on the ground that profits from the sale of property are usually not the product of the toiling and spinning of those who enjoy them is for experts on justice and social policy to

decide. The student of the Constitution can only say that he finds nothing in that instrument to forbid it. The Sixteenth Amendment allows the taxation of income from whatever source derived. This is construed to mean that the Court cannot look at the source of the income to discover that a tax on income is really a tax on property because of its ownership and so a direct tax which must be apportioned among the states according to population. If the Court must disregard the source when it is ore in place or an ancient corporate surplus, as has been authoritatively determined, it would seem that it must disregard the source when it is an increment prior to the year of realization. So that if we grant that the realized gain is income we need not care whether it is income for a particular year. Nothing in the language of the Constitution restricts Congress to the taxation of *annual* income. Nor would the fact that lumped realized gains may not be a single year's income in economics or accounting prevent it from being a single year's income in law. Where two elements, gain and its realization, are both essential to produce income, the income may be thought to arise as a legal fact when the second requisite is added to the first. If this is true of corporate dividends and proceeds from sale of ore, whether gains or not, why should it not be true of actual gains from the sale of other property? The result may be undesirable, but it is not therefore unconstitutional.

It seems to be agreed that profit from the sale of capital assets is income to one who is in the business of buying and selling. There is but one economic difference between such continuous and repeated buying and selling and an isolated instance. Numerous overlapping transactions tend to make the annual gain correspond somewhat to the annual realization of gain. No such factor is present when an investor makes a casual advantageous sale. This difference, however, relates to the question, not whether a realized profit is income, but whether it is all income for the year in which the realization occurs. It would require a little legerdermain for a court to hold any of it income for a year prior to its realization, after the clear adjudication that it cannot be income until realized.

Such tricks of relating back are now and then performed by the law, so that the feat is not impossible. It would reach a practical result quite in accord with common sense. Strong arguments may be adduced why Congress should treat the present realization of past gains as new increment to the incomes for the years in which the gains developed. The Act of 1917 took a step in this direction by applying the rates of past years to dividends from corporate gains of past years. The step was almost completely reversed later, and, under the Treasury interpretation, the Act of 1917 looked to the past only for the percentum of the rates. The income from corporate dividends was still treated as income for the year in which it was realized, and the progression was determined by reference to the income of that year. A case arising under this practice is, however, no worse than that of a lawyer who works three years for a $30,000 fee without the possibility of keeping his books on an accrual basis—either because he could not tell in advance what his fee would be or because he had no funds to pay the tax until the fee came in. All such inequities deserve legislative consideration. Nevertheless it is hard to find for them any balm in the Constitution. Even if it is conceded that profits from past gains are presently realized past income, the Constitution does not forbid the taxing of past income. This was settled in the Brushaber Case in which Chief Justice White said that the Sixteenth Amendment is satisfied if the retroactivity does not go back of its enactment, and that objections based on other clauses of the Constitution are foreclosed by *Stockdale v. Atlantic Insurance Company*.[121] His approval of that case includes a sanction of a tax on income of the previous year though one tax on it had already been paid.

## IV

This covers the questions which the Supreme Court has already considered. Other interesting issues remain to be settled. The most troublesome will be those which arise from the combination of a number of transactions indulged in by

[121] Note 86, *supra*.

the same taxpayer. Some may bring a profit, others a loss. Some losses will be realized, others will be unrealized. It seems clear that if the assessment includes only realized gains it may confine its deductions to realized losses. It is hard to find any constitutional protection against taxing realized gains and disregarding realized losses. The Sixteenth Amendment is not restricted to net income. It says "incomes, from whatever source derived." The Brushaber Case settles that Congress may tax some incomes and not others. What forbids it to separate a man's income from his loss and to tax the former and disregard the latter? Certainly, if the realization of the loss is on paper only, as in the case of wash sales, the Court will disregard it as it disregarded the paper transactions in the Stock Dividend Case and the Southern Pacific Case. For anything that appears in the Constitution or in the cases, Congress may levy on gross income. As a matter of statutory interpretation, gross income from the sale of a particular piece of property does not arise until after the deduction of its capital value at the appropriate antecedent date, except in the aberrant instance of extracts from mines. Sales at a loss would not produce even gross income. But it does not follow that such losses must be deducted before profitable transactions produce gross income. It may well be that the Court will view the question of deducting losses as one which concerns only the proper subtractions to reduce gross income to net. If this turns out to be the case, the Court will consider the question of deductions only as one of statutory interpretation. The opinion of the Chief Justice in the Brushaber Case in its roundabout way informs us that neither the Fifth nor the Sixteenth Amendments nor the requirement of uniformity hampers Congress in deciding what deductions to allow from gross income.

Above all it is to be remembered that Congress is restricted to the taxation of income only when the tax is one that would have been regarded as a direct tax within the Pollock Case. I had long assumed that the Pollock Case applied only to rents, interest and dividends; that only a tax on the ordinary, normal, recurring fruits of property was regarded as a tax in

substance on the property because of its ownership. Only such taxes have that element of unavoidable demand which is referred to in the opinions as the basis for distinguishing between direct and indirect taxes. But Mr. Justice Pitney in the Stock Dividend Case assumes that the Pollock Case applies to "taxes upon rents and profits of real estate and upon returns from investments of personal property." [122] And Mr. Justice Peckham in *Nicol v. Ames*,[123] in holding a tax on sales at exchanges to be indirect tax, says that such a tax "differs radically from a tax upon every sale made in any place" and that the latter "is really and practically upon property," because it "takes no notice of any kind of privilege or facility, and the fact of the sale is alone regarded." [124] This is dictum, but it finds some support in the decision in the Stock Dividend Case, in that the Court there seemed to assume without discussion that a tax on a stock dividend is a tax on the property in the parent stock because of its ownership. I do not see why the issue or receipt of a stock dividend is not as much a proper subject of indirect taxation as a tax on an agreement to sell a share of stock or on the use of a foreign-built yacht. I do not see how a tax on the sale of property or the proceeds thereof or the gain therein is a tax on the property because of its ownership. It may be that the Supreme Court now thinks that the principle of the Pollock Case is that taxes on the yield of property itself, whether by sale or otherwise, are in substance taxes on the property itself. If so, that yield must be income in order to be subject to an indirect tax.

This does not apply however, where the yield represents something more than intrinsic enhancement of the property itself. I say "intrinsic enhancement," to distinguish the increment which inheres in the property itself from the gain realized by changing its form or displaying it in an emporium and then selling it. The gains of a manufacturer or regular trader or the process of manufacturing or trading seem to be thought of as subjects of indirect taxation which is not taxa-

[122] 252 U. S. 189, 205.
[123] Note 18, *supra*.
[124] 173 U. S. 509, 521.

tion on the property itself because of its ownership. According to the opinion of the Chief Justice in the Baltic Mining Case, a tax on such operations is an indirect tax independently of the effect of the Sixteenth Amendment. Being indirect, it may be measured in other ways than by income, net or gross. If Congress clearly indicates how it wishes such taxes to be measured, it cannot matter that it calls its measure "income" when the court thinks that in truth it is not. "Income" as used by Congress in any tax which is in no respect within the Pollock Case need not be "income" that is taxable as such under the Sixteenth Amendment. The Sixteenth Amendment does not limit the power previously enjoyed by Congress. It merely removes the requirement of apportionment from taxes on income that are in substance taxes on property. Clearly, therefore, any tax on the proceeds of business transactions or on business done or on being in business, which is unmixed with a tax on the sort of income or proceeds that are within the shelter of the Pollock Case, has nothing to fear from the requirement that direct taxes be apportioned among the states according to population. In respect to such a tax, the federal government has, at the very least, all the latitude in finding modes of assessment that the states enjoy in measuring their excises.

This is not to say that the present Income Tax Act may get at any proceeds that might be reached by an excise on business. If the taxpayer's return includes amounts that could not be reached under the Pollock Case and which can therefore be taxed only under the Sixteenth Amendment, the Supreme Court may well hold that he may exclude from his return anything that is not income within the meaning of the Amendment. This seems to me the ground on which the Stock Dividend Decision should have been put. It should have recognized that a separate tax on stock dividends would have been an indirect tax, but have held that a transaction or the proceeds thereof on which a tax would be an indirect tax may not be included in the assessment of an income tax proper unless the proceeds are genuine income. But the theory on which the case proceeded leaves us in doubt. The doubt, how-

ever, should be confined to cases where the taxpayer's return includes items which would not be taxable except for the Sixteenth Amendment. If the items in the return are exclusively proceeds from business, a tax thereon is an indirect tax whether within the Sixteenth Amendment or not. Of course it is possible for the Court to say that when Congress professes to tax only income, it will be held to its professions. However, any such restriction would readily be overcome by a simple change in the wording of the law. The reason why genuine income should not be mixed with something else is because the rates are based on what it is thought genuine income can stand. Since both the proceeds from business and the income proper are separately taxable, their confusion in a single tax affects only the rates of levy. Such a confusion which affects only the rates was sanctioned in *Maxwell v. Bugbee* [125] which in effect allowed New Jersey to look to extra-state, non-taxable assets in order to fix the rate of an inheritance tax on the New Jersey assets passing by the will of a nonresident. The principle of that five-to-four decision would stand in the way of constitutional relief from the commingling under consideration. But the principle, happily, is not one of universal application. Indeed an apology is needed for its application in any case.

In closing, a word should be said about rates and about double taxation. In a recent case involving a state tax, Mr. Justice Holmes said that the Fourteenth Amendment no more forbids double taxation than it does doubling the amount of the tax.[126] Nothing in the Constitution forbids taxing the income of the corporation and taxing the dividends of the stockholders. Each tax may be progressive. This was settled in the case of personal income on the authority of the cases sustaining progressive inheritance taxation. Nice theoretical distinctions may be drawn between state progressive inheritance taxation and federal levies of the same character. Similar distinctions exist between progressive inheritance taxation and progressive income taxation. But these distinc-

[125] (1919) 250 U. S. 525.

[126] Ft. Smith Lumber Co. *v.* Arkansas (1920) 251 U. S. 532, 533.

tions have not been regarded by the courts. Though the progressive tax on corporations has not been the subject of explicit adjudication in the Supreme Court, it cannot be doubted that it will be sustained for the reasons given by Mr. Ballantine in his admirable article on the Excess Profits Tax in the *Yale Law Journal*.[127] Yet the Excess Profits Tax, even if it were made wholly equitable as between different corporations, is haphazard and slapdash in its treatment of stockholders. What they have paid for their stock depends in most cases on anticipation of earnings. Earnings of a hundred per cent. on what has been put into the corporate property may be earnings of only ten per cent. on what the present stockholders have paid for their stock. In reality it is the stockholders who pay the tax. But the artificial idea that the corporation is entirely distinct from its stockholders causes the courts to neglect the substance here as they neglect it in deciding what is a fair return on a fair value for the purposes of rate regulation. If it were to be wholly neglected, corporations should be allowed to deduct dividends as well as interest payments on bonds. If we wish higher taxation of unearned incomes than of earned incomes, we could know better just what we were doing if we went about it directly instead of accomplishing it to an extent in putting a progressive tax on corporate earnings on one basis and a progressive tax on those same economic earnings on another basis when they pass on to the stockholders. But these economic oddities and inequities raise no questions of constitutional law. They help to show why I end as I began by saying that the constitutional aspects of federal income taxation are relatively unimportant. My paper might almost be summarized as was that of a distinguished psychologist. A friend told him how much he enjoyed his lecture. "But you weren't there," was the surprised response. "No," was the rejoinder, "but Jones gave me an excellent summary of it. He told me that you spoke on imageless thought and said that there wasn't any."

[127] *Cit. supra.*, note 40.

# THE LEGAL FORCE AND EFFECT OF TREASURY INTERPRETATION

BY

FRED T. FIELD

Rulings of the Treasury which involve interpretations of income tax statutes are of two classes: (1) rulings in particular cases, and (2) rulings of general application. Knowledge of rulings made in particular cases may be left to inference from the acts of the Treasury. Ordinarily, however, such a ruling is embodied in a letter to the taxpayer in the particular case. Such rulings may find their way into the *Bulletin of Income Tax Rulings* published by the Treasury in the form of Solicitor's Opinions, Solicitor's Memoranda, Committee on Appeals and Review Recommendations and Memoranda (succeeding to Advisory Tax Board Recommendations and Memoranda) and Office Decisions. Rulings of general application are ordinarily embodied in Treasury Regulations or Treasury Decisions, though occasionally such rulings of lesser importance are embodied in so-called Treasury Mimeographs or in Solicitor's Opinions or Memoranda or Committee on Appeals and Review Recommendations and Memoranda.

The authority to make rulings is to be found either in the express statutory delegation to the Commissioner of Internal Revenue acting "under the direction of the Secretary of the Treasury" of the general supervision of the assessment and collection of income taxes,[1] the express statutory delegation of power to the Commissioner to do various acts involved in such collection and assessment and in the necessary implications from these delegations of power, or in the express

[1] Rev. Stat., Sec. 321.

statutory delegation of power to the Commissioner "with the approval of the Secretary" to make all needful rules and regulations for the enforcement of the provisions of the income tax statutes.[2] To a limited extent collectors and subordinate officers have statutory duties to perform which involve interpretation of income tax laws, but as these duties are performed under the general supervision of the Commissioner substantially all Treasury rulings are to be attributed to him acting under the direction or with the approval of the Secretary.

*1. Rulings in Particular Cases.* We consider first rulings in particular cases. Such rulings, as already indicated, may be merely implied from acts of the Treasury or may be expressly stated. Whether expressly stated or not, interpretation of statute is involved in each act of the Treasury, whether it be assessment, collection, refund or any act incident to one of these major acts. To the extent that one of these acts is binding the interpretation of statute involved therein is binding in the particular case. A preliminary inquiry is, therefore, as to the legal force and effect of these acts of the Treasury.

(a) Acts. Assessment is ordinarily the first act of the Treasury in dealing with a particular case. Requirements as to the keeping of records and the making of returns are usually of general application though, of course, in the enforcement of such requirements particular taxpayers must be dealt with. There is, however, statutory authority for certain acts with respect to particular taxpayers which are to be performed before assessment. Thus, for example, the Commissioner may require a person to make such statements as he deems sufficient to show whether or not such person is liable to tax.[3] He may extend the time for filing returns and paying the tax and may on the other hand in certain cases advance the time for payment of the tax.[4] So, apparently, the Commissioner may with the approval of the Secretary

[2] 1918 Law, Sec. 1309.

[3] *Ibid.*, Sec. 1305.

[4] *Ibid.*, Sec. 250.

require the use of inventories in a particular case.[5] His approval, moreover, is required for a change in the fiscal year for which a particular taxpayer files his return.[6] I pass these and similar acts without further discussion.

Assessment—the determination by the Commissioner of the amount of tax due from an individual or corporation—plays an important, though not an essential, part in income tax procedure. Though an assessment is not essential to establish obligation [7] and suit may be brought without assessment,[8] an assessment is *prima facie* evidence in a suit by the United States of the amount due [9] and an assessment is the basis for distraint. (Probably in the case of the Revenue Act of 1918 a taxpayer's computation is a sufficient basis for distraint for the first instalment of the tax shown by such computation and possibly for later instalments). Thus assessment by the Commissioner (and probably self-assessment) even though based on erroneous interpretation is effective to the extent that it warrants the taking of a taxpayer's property, subject, however, to appeal to the courts, upon questions as to liability and amount of tax. An assessment is, therefore, protection to the collector in making collection.[10] An assessment by the Commissioner, however, does not bind him not to make an additional assessment within the time allowed by the statute for making assessments, nor prevent the Government from bringing suit for an amount greater than the assessment.[11] Abatement is merely correction of assessment.

Collection of a tax places the burden on the taxpayer of showing that the tax is illegal or excessive in amount and concludes the taxpayer unless he appeals within the period fixed by statute. The act of collection thus affects a taxpayer's rights even though it is based upon an erroneous interpretation. Collection, like assessment, does not bar the

[5] *Ibid.*, Sec. 203.
[6] *Ibid.*, Sec. 212.
[7] Dollar Savings Bank, *v.* U. S., 19 Wall. 227.
[8] U. S. *v.* Grand Rapids & Indiana Railway Co., 239 Fed. 153.
[9] U. S. *v.* Rindskopf, 105 U. S. 418.
[10] Harding *v.* Woodcock, 137 U. S. 43.
[11] N. Y. Life Insurance Co. *v.* Anderson, 257 Fed. 576.

Government from further assessment and collection. A compromise made in accordance with the provisions of the statute [12] is conclusive upon both Government and taxpayer even though entered into by reason of an erroneous interpretation of statute.[13]

The Commissioner in accordance with regulations of the Secretary may refund taxes erroneously or illegally assessed or collected.[14] Application for such a refund must be made to the Commissioner before suit can be brought in court. If the Commissioner rejects the claim or fails to act within six months suit may be entered.[15] If, however, he allows the claim his decision cannot be reviewed as to the facts but may be reviewed as to the law by the Court of Claims. Such a question of law would be raised by the Comptroller of the Treasury refusing to approve the payment. A further question which I shall not discuss is the extent to which a Commissioner is bound by his own or his predecessor's rulings upon claims for refund.

My purpose in referring to these acts of the Treasury is to show that an interpretation of the Treasury may be merged in an act and that this act may have a legal force and effect irrespective of the correctness of the interpretation itself.

(b) Interpretations Embodied in Acts. An interpretation of statute which is embodied in an effective act binding upon a particular taxpayer is also of importance with respect to other taxpayers in that it furnishes some indication as to the manner in which the Treasury will act in a similar case, though, of course, the Treasury is not legally bound to follow its own precedents. If, however, an interpretation is frequently applied it may come to have the effect of long-continued departmental practice. What that effect is, I consider in connection with interpretative rulings of general application. It may be added that the publication of rulings in particular cases in the *Bulletin of Income Tax Rulings* adds nothing to their force.

[12] Rev. Stat., Sec. 3229.

[13] Sweeney *v.* U. S. 17 Wall. 75.

[14] Rev. Stat., Sec. 3220.

[15] *Ibid.*, Sec. 3226.

The Treasury in each such *Bulletin* carefully warns taxpayers that:

the rulings have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of law which has not been formally approved and promulgated by the Secretary of the Treasury. Each ruling embodies the administrative application of the law and Treasury Decisions to the entire state of facts upon which a particular case arises.

These rulings are published in order that:

"Taxpayers and their counsel may obtain the best available indication of the trend and tendency of official opinion" in the administration of the income tax statutes.

2. *Rulings of General Application.* In the absence of express authority therefor undoubtedly the Commissioner, acting under the direction of the Secretary, could make regulations of general application with regard to the manner of carrying on the business of his office. Such regulations are merely administrative directions to a group of subordinates and do not differ in nature from specific directions addressed to a single subordinate. How far such regulations would be binding upon the public need not be considered since there is in the statute here under consideration express authority for making rules and regulations.

The Revenue Act of 1918 contains a general provision authorizing the making of "all needful rules and regulations for the enforcement of the provisions of this Act." [16] It also contains provisions authorizing the making of rules and regulations with respect to specific subjects. This is true with respect to net losses,[17] depletion,[18] charitable contributions,[19] payment of tax at the source,[20] appeals from collectors in cases of understatement in returns,[21] consolidated returns,[22] collection of foreign items,[23] allocation of deductions in cases of Government

[16] Sec. 1309.
[17] Sec. 204.
[18] Sec. 214, 234.
[19] Sec. 214.
[20] Sec. 217, 221.
[21] Sec. 228.
[22] Sec. 240.
[23] Sec. 259.

contracts,[24] corporations which are in part personal service corporations,[25] rate of tax applicable to special cases,[26] taxation of trade or business carried on for part of the taxable year by an individual or partnership and for part of the year by a corporation,[27] computation of invested capital for pre-war year.[28] Regulations with regard to making public tax returns require the approval of the President as well as of the Secretary.[29] There is also a general provision of law applicable to all executive departments that the head of each department is authorized:

> to prescribe regulations not inconsistent with law for the government of his Department, the conduct of its officers and clerks, the distribution and performance of its business and the custody, use, protection and preservation of the property appertaining to it.[30]

(a) Classification. Broadly speaking, rulings of the Treasury Department of general application may be grouped in two classes—administrative rulings and interpretative rulings. An administrative ruling is one which deals with procedure. It is addressed to the enforcement of the law. Typical rulings of this character are the rulings with respect to the forms upon which returns shall be made, the statute providing that persons liable to the tax shall render such returns "as the Commissioner with the approval of the Secretary may from time to time prescribe." [31] An interpretative ruling on the other hand is one which purports to state the meaning of the statute. An example of such a ruling is that with respect to income not reduced to possession—constructive receipt.[32] That regulation while recognizing that a taxpayer may report his income on the basis of actual receipts and disbursements provides that:

> Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for

[24] Sec. 301.
[25] Sec. 303.
[26] Sec. 328.
[27] Sec. 330.
[28] Sec. 330. *Cf.* also Refunds, Rev. Stat., Sec. 3220.
[29] Sec. 257.
[30] Rev. Stat., Sec. 161.
[31] 1918 Law, Sec. 1305.
[32] Reg. 45, Arts. 53, 54.

the year during which so credited or set apart although not then actually reduced to possession.

In other words, the Treasury says that, as a matter of interpretation of statute, income is received when it is credited to the account of or set apart for a taxpayer under the circumstances described. Of course, it is not my purpose to discuss the question as to whether this regulation is good law. I refer to it merely as an example of interpretative regulations. There may be, however, as we shall see, rulings which do not readily fall into either of these classes.

(b) Administrative Rulings. The statutory provisions referred to clearly purport to confer upon the Treasury authority to make administrative rulings. That Congress may delegate such power is well settled and such regulations have the force of law. In the recent case of *Maryland Casualty Company v. U. S.*[33] Mr. Justice Clark said:

> It is settled by many recent decisions of this Court that a regulation by a Department of Government addressed to and reasonably adapted to the enforcement of an act of Congress, the administration of which is confided to such Department, has the force and effect of law if it be not in conflict with express statutory provision.

An indication of the kind of regulations referred to in this statement may be obtained from an examination of the cases cited in support of it. In one of these cases [34] a regulation of the Secretary of Agriculture requiring permits for the use and occupancy of public forest reserves was held valid, the Secretary being authorized by statute "to regulate the occupancy and use and to preserve the forests from destruction."

In another case [35] a regulation of the Bureau of Indian Affairs which required subordinates to report violations of law with respect to traffic in intoxicating liquor with the Indians was held valid, one of the important duties of the Indian office being the enforcement of such legislation. In the other cases cited [36] regulations prescribed by the Commissioner of the Land Office with the approval of the Secretary of the Interior requir-

[33] 251 U. S. 342, p. 349.
[34] U. S. *v.* Grimaud, 220 U. S. 506.
[35] U. S. *v.* Birdsall, 233 U. S. 223.
[36] U. S. *v.* Smull, 236 U. S. 405; Morehead *v.* U. S., 243 U. S. 607.

ing affidavits from applicants for public lands were held to be valid so that the making of false affidavits constituted perjury under a statute making false swearing perjury, "in any case in which a law of the United States authorizes an oath to be administered."

Similar decisions have been made in internal revenue cases. Thus in *In Re Kollock* [37] the court sustained a regulation of the Treasury prescribing the method of marking oleomargarine packages. The court said:

> The designation of the stamps, marks and brands is merely in the discharge of an administrative function and falls within the numerous instances of regulations needful to the operation of machinery of particular laws, authority to make which has always been recognized as within the competency of the legislative power to confer.[38]

In *Boske v. Comingore* [39] a regulation of the Treasury Department, which declared that records in the offices of Collectors of Internal Revenue were in their custody and control "for purposes relating to the collection of the revenues of the United States only" and that collectors "have no control of them and no discretion with regard to permitting the use of them for any other purpose" was held to protect a collector against an order of a state court for the production of such records for use as evidence. It will be seen that the regulations considered in the cases were procedural. They had to do with the method of enforcing the statute and did not affect substantive rights.

The tests of validity of an administrative regulation laid down in Maryland Casualty Case[40] are: (1) that it be addressed to the enforcement of an Act of Congress, the administration of which is confided to such department—that is, the officers must have jurisdiction; (2) that it be reasonably adapted to such enforcement and (3) that it shall not be inconsistent with any specific statutory provision. This third test means not merely that the executive department cannot make admin-

[37] 165 U. S. 526.

[38] *Cf.*, however, U. S. *v.* Eaton, 144 U. S. 677.

[39] 177 U. S. 459.

[40] *Cf. supra*, p. 97.

istrative regulations which are contrary to statute but also that they cannot make regulations which add to the statute. In *U. S. v. George* [41] this phase of the rule was applied. A statute which dealt with homestead claims for public lands required two credible witnesses to residence upon or cultivation of such land by the claimant. A regulation of the Department of the Interior in substance required three. The Court held that "Congress had provided the 'exact measure' of the claimant's obligation and that the Department could neither add to nor detract from it." The power of the Department to regulate exists when the statute is silent as to method. It is merely a "power to fill in details."

The rule of decision applicable where the validity of a departmental, administrative regulation is drawn in question was stated in the case of *Boske v. Comingore*, already referred to,[42] in the following terms:

> In determining whether the regulations promulgated by him [that is the Secretary of the Treasury] are consistent with law, we must apply the rule of decision which controls when an act of Congress is assailed as not being within the powers conferred upon it by the Constitution; that is to say, a regulation adopted under Sec. 161 of the Revised Statutes (and the rule must be equally applicable to other statutes delegating the power to make regulations) should not be disregarded or annulled unless, in the judgment of the court, it is plainly and palpably inconsistent with law. Those who insist that such a regulation is invalid must make its invalidity so manifest that the Court has no choice except to hold that the Secretary has exceeded his authority and employed means that are not at all appropriate to the end specified in the act of Congress.

Though the courts are very careful to state that the power delegated to an executive department to make rules and regulations is not a legislative power, the administrative rules and regulations so made are in many respects similar to statutes. Like statutes, for example, they do not ordinarily have retroactive effect. Furthermore, they are noticed judicially by the courts.

(c) Interpretative Rulings. From administrative regulations, that is, regulations dealing with procedure, we pass to inter-

[41] 228 U. S. 14.
[42] *Cf. supra*, p. 98.

pretative regulations, that is, regulations which purport to state the meaning of the statutes. The greater part of the Revenue Act of 1918, as is true of previous acts, is devoted to describing in somewhat minute detail the method of computing the amount of tax due from each taxpayer. In this computation, two factors are, of course, involved—the amount of income and the rate of tax. The rate of tax, in the case of the income tax, is determined almost entirely by the amount of income, while in the case of the excess profits tax the rate itself depends upon two factors—income and invested capital. Taxable income and invested capital are elaborately defined by the act. The Treasury in performing its function must determine the meaning of these definitions of taxable income and invested capital as well as the meaning of the rules laid down for combining the several factors so as to determine the amount of the tax. The question is as to the legal force and effect of these interpretations by the Treasury.

It has already been pointed out that specific acts may have a legal force and effect even though based upon erroneous interpretations of statutes. For example, an assessment in and of itself has a certain legal force and effect. Here, however, we consider the legal force and effect of interpretations apart from the effect of the acts as such. As these interpretations are ordinarily embodied in rulings of general application and published as regulations or Treasury decisions, the question is substantially as to the legal force and effect of the regulations and Treasury decisions which purport merely to interpret the statute. Many regulations are of this character. I have already referred to the regulation with respect to income not reduced to possession as an example of interpretative rulings. The status of regulations of this character is in the main so well settled that it would be a waste of time to discuss it if it were not for the fact that there seems to be some misapprehension on the subject.

In the first place it is to be noted that such an interpretative regulation has not the force of law. It is not binding upon the courts. It could have the force of law only on one or the other of two theories, namely, that such a regulation is made by the

Treasury in the exercise of a delegated quasi-legislative power and is in its nature a statute binding on courts as well as on administrative officers, or that such a regulation is made by the Treasury in the exercise of a quasi-judicial power to construe the statute without review by the courts. Neither of these theories is sound.

We have seen in connection with administrative regulations that to a limited extent Congress has delegated legislative power to the Treasury. The courts, however, are careful to state that the power so delegated is not strictly legislative but is a kind of administrative power. The making of interpretative regulations is not within the scope of the congressional delegation of authority. A regulation which states accurately the meaning of a statute has no legal force. The statute stands unaffected by the regulation. On the other hand, a regulation which alters or amends the statute is beyond the power of the Treasury and is, therefore, void. Let me refer to several decisions and expressions of the court. The case of *Morrill v. Jones*[43] arose under the customs law which provided that:

> Animals, alive, specially imported, for breeding purposes, from beyond the seas, shall be admitted free [of duty] upon proof thereof satisfactory to the Secretary of the Treasury, and under such Regulations as he may prescribe.

The Treasury customs regulations provided that before a collector admitted such animals free he must, among other things, "be satisfied that the animals are of superior stock adapted to improving the breed in the United States." A question arose as to the validity of this regulation and the Court, speaking through Chief Justice Waite, said:

> The Secretary of the Treasury cannot, by his regulations, alter or amend a revenue law. All he can do is to regulate the mode of proceeding to carry into effect what Congress has enacted. In the present case, we are entirely satisfied the regulation acted upon by the Collector was in excess of the power of the Secretary. The statute clearly includes animals of all classes. The regulation seeks to confine its operation to animals of "superior stock." This is manifestly an attempt to put into the body of the statute a limitation which Congress did not think it necessary to prescribe. Congress was willing to admit, duty free, all animals specially imported for breeding purposes; the Secretary

[43] 106 U. S. 466.

thought this privilege should be confined to such animals as were adapted to the improvement of breeds already in the United States. In our opinion, the object of the Secretary could only be accomplished by an amendment of the law. That is not the office of a treasury regulation.

In an earlier case, *U.S. v. 200 Barrels of Whiskey*,[44] the same Chief Justice said with respect to an internal revenue regulation:

The regulations of the Department cannot have the effect of amending the law. They may aid in carrying the law as it exists into execution but they cannot change its positive provisions.

Similar decisions and expressions with respect to regulations of executive departments are not infrequent. For example, in *U. S. v. U. S. Verde Copper Company*,[45] the Court had under consideration a regulation of the Interior Department, purporting to have been made under express statutory authority conferred upon the Secretary of the Interior to make rules and regulations, which construed a statute permitting the use of timber on public lands for domestic purposes by defining the word "domestic." The Court said [46] with reference to the regulation which defined this word:

If Rule 7 is valid, the Secretary of the Interior has power to abridge or enlarge the statute at will. If he can define one term he can another. If he can abridge, he can enlarge. Such power is not regulation; it is legislation. The power of legislation was certainly not intended to be conferred upon the Secretary.

This language in part was quoted with approval in *U. S. v. George*,[47] and *Morrill v. Jones*, *U. S. v. U. S. Verde Copper Company* and *U. S. v. George* were cited with approval in *Waite v. Macy*.[48] In *U. S. v. Standard Brewing Company*,[49] decided in January of this year, an indictment under the War-time Prohibition Act, the Court, citing several of the cases to which reference has been made, said [50]: "Administrative rulings can-

[44] 95 U. S. 575, 576.
[45] 196 U. S. 207.
[46] P. 215.
[47] 228 U. S. 14, 22.
[48] 246 U. S. 606, 609.
[49] 251 U. S. 210.
[50] P. 220.

not add to the terms of an act of Congress and make conduct criminal which such law leaves untouched."

In the recent cases decided by the Supreme Court under the corporation tax and income tax statutes, the Court has not found it necessary to discuss the principle which we have been considering. Some of these cases, such as the Stock Dividend Case and the Judges' Salaries Case, involved the more fundamental question as to the validity of the statutory provisions and it was unnecessary to consider regulations as to taxes upon such dividends and judges' salaries when the statutory provisions purporting to tax such items were invalid. The regulations fell with the statute. In other cases, the Government's contentions were not based upon regulations to such an extent that decisions against the Government were rulings as to the validity of regulations, though in the first Stock Dividend Case, *Towne v. Eisner*,[51] it necessarily followed from the decision of the Court—that stock dividends were not taxable under the Revenue Act of 1913—that the Treasury decision to the effect that they were, which was issued before the decision in the case, but not until after the dividend was declared and the stock issued, was invalid. In *Doyle v. Mitchell Brothers Co.*,[52] the Court stated that certain Treasury regulations correctly interpreted the statute. But it does not appear that in reaching its decision the Court gave any weight to these regulations. Neither in this case nor in the case of *Hays v. Gauley Mountain Coal Co.*,[53] both of which held gains accruing before the passage of the taxing statute non-taxable, was any question raised as to the propriety of the method prescribed by the regulations of apportioning gains between the period before and that after the taxing statute. In *Goldfield Consolidated Mines Company v. Scott*,[54] the government claimed a tax greater in amount than the tax ascertained in accordance with Treasury regulations made after the taxable year, but before suit was brought, but the Court held the tax valid in spite of the regulation.

[51] 245 U. S. 418.
[52] 247 U. S. 179.
[53] 247 U. S. 189.
[54] 247 U. S. 126.

Though the Supreme Court has not in the cases under the recent income tax statutes discussed the legal force and effect of Treasury regulations purporting to be made under authority of those statutes, the lower federal courts have made some statements upon the subject.

In *Edwards v. Keith*,[55] the Circuit Court of Appeals for the Second Circuit spoke with reference to the instructions of the Treasury printed upon the forms of returns and presumably issued by the Commissioner with the approval of the Secretary, to the effect that professional men should include in their returns not only actual receipts but also "unpaid accounts, charges for services, or contingent income due for that year if good and collectible," as follows:

> This form may be appropriate enough to give the Department full information about an individual's earnings in any particular year so as to enable its officers to check up with accuracy some return of a future year, when his hope of being paid what he has earned finds fruition. But no instructions of the Treasury Department can enlarge the scope of this statute so as to impose the income tax upon unpaid charges for services rendered and which, for aught anyone can tell, may never be paid. . . The phraseology of Form 1040 is somewhat obscure. . . but it matters little what it does mean; the statute and the statute alone determines what is income to be taxed.

In *De Ganay v. Lederer*,[56] the District Court said:

> Great weight and due deference is always given to departmental or other executive constructions of laws. The acceptance of such constructions is, however, always limited by the thought that the imposition of a tax is a legislative and not an executive act, and we are brought back again to the judicial construction of the statute.

In *Cryan v. Wardell*,[57] the Government claimed a tax from a lessor upon the value at the termination of the lease of a building erected by the lessee, in accordance with, as the Court (District Court for the Northern District of California) says, "an interpretative ruling of the Treasury Department made for the guidance of taxing officers." The Court held that under the terms of the lease the building became the property of the lessor

[55] 231 Fed. 110, 113.
[56] 239 Fed. 568.
[57] 263 Fed. 248.

upon its completion and was subject to taxation as of that date and said that:

the regulation of the Treasury Department cannot be applied to such a state of facts; if so intended, it must give way, as the Department has no power to abrogate a substantive rule of law.

In *First Trust & Savings Bank v. Smietanka*,[58] the Circuit Court of Appeals for the Seventh Circuit considered the liability to income tax under the Revenue Act of 1913 of undistributed income added to the principal of trust estates. The Court, after expressing approval of earlier regulations, referred to Treasury Decision No. 2231, issued July 26, 1915, which stated that:

Any part of the annual income of trust estates not distributed becomes an entity and as such liable for the normal and additional tax which must be paid by the fiduciary. When the beneficiary is not *in esse* the income of the estate is retained by the fiduciary and such income will be taxable to the estate as for an individual and the fiduciary will pay the tax both normal and additional.

The Court declared that:

This ruling was the cause of the present and other similar suits. It illustrates the not unnatural tendency of tax officers to increase the revenues by implication and strained constructions. The Department's first rulings were in harmony with the natural import of the language used by Congress: its later ruling does more than violate the canon that doubts and ambiguities are to go against the Government, for it is based, not upon any uncertainty in the terms of the act, but upon a metamorphosis of a body of property into a person, and upon exactions contrary to the exemptions in the Act of 1913. . . Congress recognized that such alterations and amendments were legislative and passed the Amendatory Act of September 8, 1916, levying a tax upon undistributed income added to the principal of trust estates.

The Court thus held the Treasury regulation invalid and the tax assessed under it improperly assessed.

The principle applicable to regulations of executive departments generally is clearly applicable to regulations of the Treasury Department which are merely interpretative of the income tax statute. The statute in authorizing the making of rules and regulations does not delegate to the Treasury Department a legislative or quasi-legislative power to amend the

[58] I. T. S. 1920, Sec. 2935–2943.

statute. Such a regulation is not in its nature a statute binding upon the courts.

We now consider whether, though an interpretative regulation has not the force of a statutory enactment, such a regulation may not be a quasi-judicial construction of the statute which is not subject to review by the courts and thus have the force of law. It is an interesting question how far Congress may confer upon an executive department the power to make conclusive adjudications. In *Bates & Guild Co. v. Payne*,[59] the majority of the Court said that there is a class of cases "where Congress has committed to the head of a department certain duties requiring the exercise of judgment and discretion" and that in such cases "his action thereon whether it involves questions of law or fact will not be reviewed by the courts unless he has exceeded his authority or this Court should be of opinion that his action was clearly wrong." The rule was summarized as follows:[60]

> where the decision of questions of fact is committed by Congress to the judgment and discretion of the head of a department, his decision thereon is conclusive; and that even upon mixed questions of law and fact, or of law alone, his action will carry with it a strong presumption of its correctness, and the courts will not ordinarily review it, although they may have the power, and will occasionally exercise the right of so doing.

Tax cases are peculiarly matters for the executive branch of the government and there are strong indications in the decisions of the Supreme Court that the final adjudication of tax liability may be conferred upon an administrative tribunal subject only to review upon the question of jurisdiction. In *Cheatham v. U. S.*,[61] the Court held that the provision that suit in the courts for refund of income taxes should be brought within six months after appeal to the Commissioner of Internal Revenue was proper and said:

> we regard this as a condition on which alone the Government consents to litigate the lawfulness of the original tax. It is not a hard condition. Few governments have conceded such a right on any condition. . . .

[59] 194 U. S. 106.

[60] P. 110.

[61] 92 U. S. 85.

while in *McMillan v. Anderson*,[62] the Court said: "The nation from whom we inherit the phrase 'due process of law' has never relied upon the courts of justice for the collection of her taxes . . . "[63]

It is, however, unnecessary to go into this question in the present inquiry for there is ample opportunity for judicial review of decisions of the Treasury Department as to tax liability both upon questions of law and questions of fact. The Revised Statutes contain provisions with respect to suits for the recovery of taxes from the taxpayer[64] as well as for suits by the taxpayer for the refund of taxes erroneously or illegally assessed or collected[65] and the multitude of internal revenue cases in the books are instances of resort to such judicial review. Since the law is reviewable by the courts it follows, of course, that questions as to construction of the statute are open.

Though interpretative rulings of the Treasury have not the force of law either as quasi-statutes or as conclusive adjudications, they are not without effect. These rulings at least have the force of expressions of opinion of experts in that particular branch of the law. This is as much as the District Court, in the case of *Rech-Marbaker v. Lederer*,[66] concedes when it says of such a Treasury ruling: "This executive construction, however, although informing and helpful is controlling only to the extent to which it is persuasive." The courts, to be sure, occasionally use expressions like that already quoted from *De Ganay v. Lederer*, to the effect that "great weight and due deference is always given to departmental or other executive constructions of laws." This statement, however, is usually limited by the proviso that the construction must have been long continued. A very late statement of the principle is found in *National Lead Co. v. U. S.*[67]

[62] 95 U. S. 37.

[63] *Cf.* also Murray's Lessee *v.* Hoboken Land & Improvement Co., 18 How. 272.

[64] Sec. 3212–3216.

[65] Secs. 3220, 3224–3227.

[66] 263 Fed. 593.

[67] 252 U. S. 140.

The Court said:

From *Edwards v. Darby*, 12 Wheat. 206, to *Jacobs v. Pritchard*, 223 U. S. 200, it has been the settled law that when uncertainty or ambiguity . . . is found in the statute great weight will be given to the contemporaneous construction by department officials, who were called upon to act under the law and to carry its provisions into effect—especially where such construction has been long continued, . . ."

In other cases, the statement with regard to long continuance is somewhat more elaborately phrased and a long-continued executive construction which is considered is said to have been "without question" [68] or, as another case has it:

When there has been a long acquiescence in a regulation and by it rights of parties for many years have been determined and adjusted, it is not to be disregarded without the most cogent and persuasive reasons.[69]

Thus there is introduced an element other than the opinion of department officials, namely, the opinion of the public dealing with the Treasury Department. In view of the emphasis placed by the Court upon the element of long continuance of a departmental construction it is to be expected that comparatively little weight will be given as an aid to construction to an interpretative ruling which has not been followed in practice for a long period of time. Of course, as is pointed out in numerous cases, departmental interpretations can be resorted to only when there is ambiguity or doubt as to the true meaning of the statute.

A further effect of an interpretative ruling may be seen in cases of re-enactment of statutes considered by it. In spite of some indications to the contrary in *Dollar Savings Bank v. U. S.*,[70] the law seems to be as stated in the National Lead Company Case, already referred to, that the re-enactment of a statutory provision which has received executive interpretation

amounts to an implied legislative recognition and approval of the executive construction of the statute, for Congress is presumed to have legislated with knowledge of such an established usage of an executive department of the government.

[68] *Cf.* U. S. *v.* Baruch, 223 U. S. 191, 200.
[69] Robertson *v.* Downing, 127 U. S. 607.
[70] 19 Wall 227.

Of course, interpretative rulings, as a practical matter, have considerable effect other than as aids to construction. They are instructions to subordinates in the Treasury as to the method to be used by them in computing taxes. This is their primary purpose. The method used by the Treasury in computing taxes is of vast importance to taxpayers, for only comparatively few of them appeal from the decision of the Treasury and the interpretation placed by the Treasury upon the statute is conclusive upon those who do not litigate or successfully save their rights so as to benefit by the litigation of others. When a taxpayer's liability has been definitely fixed by the expiration of the time for appeal from the Treasury it is of little moment to him that this liability was fixed in accordance with an erroneous interpretation of statute.

It is conceivable, moreover, that an erroneous interpretative regulation may lead to the imposition of some administrative requirement which, while not so unreasonable when tested by a correct interpretation of the statute as to be invalid, would not have been made by the Treasury if it had interpreted the statute correctly. This is illustrated in the case of *Edwards v. Keith*, to which I have already referred.

Finally an erroneous interpretative ruling may have, indirectly, legal as well as practical effects. There can be no doubt that strict compliance with such a ruling will relieve a taxpayer from any charge of fraud or bad faith though it will not relieve him from liability to be taxed in accordance with the correct interpretation of the statute, if such liability is asserted by the Government before the Statute of Limitations has run in favor of the taxpayer. Similarly such an erroneous interpretative ruling will relieve a subordinate officer or agent of the Treasury from the charge of fraud or bad faith.[71]

An interpretative ruling cannot in the strict sense be retroactive. Since such a ruling has not the effect of law it is not legally *active* at all. Its indirect and practical effects may, however, be retroactive. Conceivably, the effect of a ruling as an aid to construction may be retroactive. So far as compliance with an erroneous ruling shows good faith and absence of

[71] *Cf.* Tracy *v.* Swartout, 10 Pet. 80.

fraud it cannot, of course, have a retroactive effect. There is no such indication unless the person whose action is in question knew of the ruling when he acted.

As a matter of departmental administration, an interpretative ruling may or may not be applied retroactively. The Commissioner of Internal Revenue, like other administrative officers, is bound to enforce the law. Administrative officers are required to use their best judgment as to the meaning of a statute. The later judgment in the case of a changed ruling is presumably the better, else the change would not have been made. It seems to me clear that cases which have not been closed should be disposed of in accordance with the later ruling. Indeed, theoretically all cases in which the Government is not legally barred should be reopened and settled in accordance with the later and better judgment. As a practical, administrative matter, however, the question as to how far the Treasury should go in reopening cases, which have been closed though the Government is not legally barred, cannot be so easily disposed of. Clearly when a case is reopened by the taxpayer it must be disposed of on the basis of the later ruling, but I have grave doubt as to whether ordinarily it is the duty of the Treasury of its own motion to reopen cases which have been disposed of on the basis of earlier rulings. At any rate, when the administrative burden is so great as it is under the present statute I think that the Treasury should give precedence to current matters. If it does so, the natural result will be that it will not have the opportunity to reopen the earlier cases before the Statute of Limitations has run, and this result will not be a bad one. There are, however, extraordinary cases to which the administrative practice of letting sleeping dogs lie, which I have suggested, cannot properly be applied. Such a practice, for example, is hardly applicable where decisions of the Supreme Court require fundamental changes in rulings. Furthermore, the disposition of current cases frequently depends upon the disposition of earlier ones and there is something to be said for reviewing the entire series, as there is where a taxpayer seeks to have the cases reopened which are in his favor, when there are cases for other years in which the Government would bene-

fit by the reopening. The merit of the legislation proposed at the last session of Congress, and passed by the House of Representatives, with respect to the retroactive application of regulations,[72] and I think its only merit, would be to give to the Treasury statutory sanction for refraining from reopening cases which have been closed. In view of the nature of interpretative regulations, however, the proposed legislation is theoretically unsound, and would be practically objectionable to the extent that it prevents the Treasury reopening cases upon motion of the taxpayer and the exceptional cases referred to.

In my opinion, the true solution of the evil of changed interpretative regulations lies in an administrative development of the Treasury to a point at which it will be able to keep its work as nearly current as is possible and in the passage of a short statute of limitations—much shorter than the present five-year statute.[73] If, however, the Government is barred by a short statute of limitations taxpayers also should be so barred and Congress should harden its heart against the passage of bills for the extension of the period within which suit can be brought to recover taxes paid.

(d) Regulations Fixing Standards. In the preceding analysis, I have attempted to classify rulings as either administrative or interpretative. Some rulings, however, do not fall readily into either class. For example, what should be said of a ruling made under the provision of statute that if a taxpayer employs no method of accounting or "if the method employed does not clearly reflect the income, the computation shall be made . . . in such manner as in the opinion of the Commissioner does clearly reflect the income." [74]

A ruling prescribing a method of accounting is not, like a ruling prescribing a form of return, solely administrative. It is something more than procedural for it may substantially affect the amount of the tax. Such a ruling might conceivably be regarded as interpretative on the theory that income is

[72] H. R. 14198, sec. 5.

[73] *Cf.* 1918 Law, Sec. 250, 252.

[74] *Ibid*, Sec. 212.

defined by statute and that there can be but one method of accounting which clearly reflects it. This, however, is not the statutory conception. The statute contemplates that income may be measured by actual receipts and disbursements or by accruals, and certainly there is more than one method of accrual accounting. Something is left to the "opinion of the Commissioner." There is, therefore, probably some element of quasi-legislation in prescribing a method of accounting and consequently a regulation upon this subject is more than merely interpretative. Such a regulation may, I think, be properly classed with those of which the regulation sustained in *Buttfield v. Stranahan*,[75] is a type. In that case the Court sustained a statute which prohibited the importation of teas inferior to the Government's standards of purity, quality and fitness for consumption and authorized the Secretary of the Treasury to establish such standards. The Court said:[76]

> Congress legislated on the subject as far as was reasonably practicable, and from the necessities of the case was compelled to leave to executive officials the duty of bringing about the result pointed out by the statute.

and that: [77]

> the sufficiency of the standards adopted by the Secretary of the Treasury was committed to his judgment to be honestly exercised.

In connection with this case is to be considered the later case under the same statute, as amended, of *Waite v. Macey* already referred to, which held that the standard fixed was not a standard of "purity, quality or fitness for consumption," and that the scope of the authority conferred by the statute to fix standards had been exceeded.

Upon the authority of these cases it may be said that Congress, having under the Constitution the power to impose a tax on income, may authorize the Commissioner of Internal Revenue to prescribe methods of accounting and thus to an extent fix a standard of taxable income, provided, of course, that such standard does not result in the imposition of a tax

[75] 192 U. S. 470.
[76] P. 496.
[77] P. 497.

upon anything which is not income under the statute or the Constitution. In this connection, it is interesting to note that in the *Brushaber Case*,[78] the Supreme Court cited *Buttfield v. Stranahan* and similar cases in support of the proposition that the Revenue Act of 1913 was not invalid because certain administrative powers to enforce the act were conferred by the statute upon the Secretary of the Treasury.

So far as the question as to the retroactivity of regulations of this third class is concerned, the rule would seem to be the same as in the case of purely administrative regulations, but it may be that such regulations are not retroactive if made at any time before computation of the tax.

*Summary.* In brief, Treasury rulings may have effect in and of themselves or may be the basis of acts which are themselves effective. An act even though based on an erroneous ruling may by lapse of time without appeal to the courts or in some other way become binding upon the Government, the taxpayer, or both. Rulings are of two principal classes—administrative rulings which deal with procedure and interpretative rulings which purport to state the meaning of the statute and to affect substantive rights. Administrative rulings are made under authority of a delegated quasi-legislative power and, if within the scope of the delegation, have the effect of law as quasi-statutes. They are presumed to be valid. Interpretative rulings have no effect as law since they are not within the delegation of quasi-legislative power and since no power of conclusive quasi-judicial construction is given to the Treasury Department. Interpretative rulings are, however, under some conditions aids to the construction of the statute and have certain important practical effects. There is probably a third class of rulings which are quasi-legislative in character made under a delegation of power to fix standards and which to a limited extent affect substantive rights.

[78] 240 U. S. 1.

# REORGANIZATIONS AND THE CLOSED TRANSACTION

BY

Lt. Col. Robert H. Montgomery, C. P. A.

No phase of federal income tax law and procedure has been more perplexing and annoying than the determination of the tax, if any, which can or should be imposed in respect of the exchange of property for other property, when the property received is other than cash. Difficulties do arise even when property is sold for cash, but this discussion treats only of transactions in which the consideration moving to the owner of property is not cash. In other words, we shall only discuss cases where some question can arise as to whether or not a certain transaction is a "closed" transaction within the meaning of the federal income tax law.

Before quoting from the law it is important to consider the regulations of the Treasury, because if the regulations were clear and fairly dependable interpretations of the law it would not be necessary to do more than state the regulations.

Article 1563 of Regulations 45 reads, in part, as follows:

> *Exchange of Property.* Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (*a*) that is essentially different from the property disposed of and (*b*) that has a market value. In other words, both (*a*) a change in substance and not merely in form, and (*b*) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized. By way of illustration, if a man owning ten shares of listed stock exchanges his stock certificate for a voting trust certificate, no income is realized, because the conversion is merely in form; or if he exchanges his stock for stock in a small, closely held corporation, no income is realized if the new stock has no market value, although the conversion is more than formal; but if he exchanges his stock for a liberty bond, income may be realized, because the conversion is into independent property having a market value.

No fault can be found with the foregoing. It is a reasonable interpretation of that part of the Revenue Act of 1918 which deals generally with the exchange of property for other property. Unfortunately, however, the article is not construed as it reads and there are other regulations which conflict with Article 1563. Furthermore the law itself, in the sections dealing with reorganizations, prescribes a method of determining profit or loss which is of questionable constitutionality and which is extremely difficult to apply and administer.

One of the latest rulings under Article 1563 is the following:[1]

> The exchange or surrender of the stock of one corporation for stock in another corporation, the beneficial interests remaining the same, is an exchange of property for other property within the meaning of Section 202 of the Revenue Act of 1918, as a result of which the stockholders sustain a deductible loss or realize profit subject to tax as the case may be.

The ruling, taken by itself, greatly narrows Article 1563, but it is in line with the present procedure of revenue agents, and additional taxes are being assessed in cases where the "property" exchanged is the stock of closely held corporations with no real market value.

The words "the beneficial interests remaining the same" as used in the foregoing ruling are diametrically opposed to the spirit and the words of the Supreme Court decisions. If the beneficial interests in so-called new property remain the same as in the old property, how can it be claimed that the mere act of transfer, or the exchange of one kind of paper for another kind of paper, results in income, which may *lawfully* be taxed under the Constitution?

Disposing of the question of constitutionality it is interesting to note that Congress and the taxing authorities seem to care very little about the limitations of the Sixteenth Amendment to the Federal Constitution and it has required more than one decision of the Supreme Court to make clear what should be obvious, *viz.:* Congress under the Sixteenth Amendment has the power to tax *income* but has no power to tax property without apportionment. If an exchange yields

[1] *Bulletin*, 34–20, p. 35.

no "income" to the taxpaper no tax can lawfully be assessed even though the law or the Treasury calls it a closed transaction.

It is possible that many of the seeming difficulties in connection with reorganization and so-called closed transactions have arisen from an attempt to understand and follow the numerous regulations which have been issued, amended, withdrawn and superseded. It is suggested that in any given case the regulations be temporarily ignored and consideration be given to the question "Does the transaction result in the receipt of income?" If it does we can proceed to determine the amount of the income which has been realized. If it does not, why bother with the regulations?

Any consideration of these questions requires a definition of the word "income." It is, however, unnecessary to define the word "income" in any other way than that found in the Supreme Court decisions. If no definition were found in the decisions, we would consult the dictionaries and cite common usage. The mere calling something "income" on the part of Congress or the Treasury and then taxing it as income does not change something else to income if it is not income within the meaning of the Sixteenth Amendment.

It may fairly be assumed that in the case of *Eisner v. Macomber* [2] the Supreme Court, having before it a case which depended on an interpretation of the word "income," gave more careful consideration to its constitutional meaning than had theretofore been given, and we may safely rely on the definitions given in the decision. The following language was used by Mr. Justice Pitney:

> A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.
>
> In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified

[2] 252 U. S. 189.

by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not "income" as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term "income," as used in common speech, in order to determine its meaning in the Amendment; and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

After examining dictionaries in common use (Bouv. L. D.; Standard Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (*Stratton's Independence v. Howbert*, 231 U. S. 399, 415; *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 185)—"Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets to which it was applied in the Doyle case (pp. 183, 185).

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. "Derived-from-capital"—"the gain-derived-from-capital," etc. Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being "derived," that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal; that is income derived from property. Nothing else answers the description.

. . . Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term.

. . . But we regard the market prices of the securities as an unsafe criterion in an inquiry such as the present, when the question must be, not what will the thing sell for, but what is it in truth and in essence.

That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question; and that such interests might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But

that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this Court.

Taxpayers are justified in relying on the foregoing decisions when determining income tax liability. As quoted above, income is "not a growth or increment of value in the investment; but a gain . . . severed from . . . and coming in . . . that is income derived from property . . . more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term."

Some of the court decisions go so far as to say that gains or income must be realized in cash before they can be taxed, but it is not necessary to go that far. Taxpayers will be content if actual income and not unrealized income is taxed.

It is evident that there is a conflict between the law and the regulations. One must therefore discuss the subject on its merits.

A discussion of exchanges and the closed transaction as related to federal income and profits taxes requires consideration of such points as these: Is the present law fair? If unfair, wherein should it be changed? If fair, is it being interpreted and administered equitably?

As will be developed later, the present law is the result of a last-minute compromise so that it is difficult to interpret. Many of the suggestions for amendments, however, arise from improper administration rather than from defects in the law. It is true that some changes in the law are desirable, but it is equally true that a more reasonable and logical administration would make the present law less obnoxious. I am not advocating an illegal administration nor even an administration which resolves every doubt in favor of the taxpayer. I do advocate an interpretation of the law which can be applied to actual income and actual gains. Deciding a doubtful point in favor of a taxpayer does not foreclose the Treasury's power to collect a tax subsequently, that is as soon as the realization of income or gains becomes a fact and enough cash or the equivalent of cash is in sight to pay the tax.

The case is not the same as where business profits for a particular year are in question. The decisions in such cases usually are final, but in reorganizations and exchanges the so-called new property can readily be followed and in many cases the government would collect more tax if it were to accept the taxpayers' contention that a transaction is a continuing one than if it were to insist that it is a closed one.

The action of taxpayers themselves has led the Treasury to impose a tax where none might be imposed under ordinary circumstances. "A" exchanges property which cost in 1918 $100,000 for capital stock of a par value of $150,000. If it is a close corporation it is quite possible that it would be held that the transaction was not a closed one and no tax would be assessed unless and until the stock was sold. But in most cases "A" is the dominant factor in the corporation. As an officer and director he goes on record that the property is actually worth $150,000 in order that the stock may be issued fully paid and the Government takes his word for it and imposes a tax. I do not think that the position of "A" is as inconsistent as it sounds. It is not a closed transaction. No income has been realized, therefore he as an individual is not required to place any value on the stock. It merely takes the place of the property which cost $100,000. If the property is worth $150,000 the directors of the corporation, including "A," are within their rights in issuing stock in exchange therefor having a par value of $150,000.

There is little criticism when a tax is imposed upon the profit arising from a sale or exchange, the proceeds of which are "the equivalent of cash." If a taxpayer receives the equivalent of cash, it is a fair inference that he will be able to pay any reasonable amount of tax which may be assessed in respect thereof. If there is an insuperable difficulty in paying the tax, the difficulty probably arises from the fact that the transaction in question is not a closed one. The law itself except in the reorganization section is not defective because nothing could be more emphatic than the language of the present law which presupposes the equivalent of cash before the tax can be levied.

The illustrations in the regulations would be satisfactory if the Treasury itself were governed by them. Certainly the exchange of a house for Liberty bonds should be regarded as a closed transaction. The exchange of a house for active stock exchange securities is also a closed transaction. But the exchange of a house for another house should not be deemed to be a closed transaction. The exchange of a cow which cost $100 for a horse worth $500 closely approaches the stock exchange security transaction because there is always a market for horses. It is not believed, however, that many exchanges or sales by farmers are returned as taxable.

Much should be left to the good faith of the taxpayer. If the property received in exchange is the same property in another form it should never be considered to be the equivalent of cash. The intention of the parties to a sale or exchange is not difficult to ascertain in most cases. The exchange of a house for Liberty bonds or stock exchange securities indicates that the owner is to that extent getting out of real estate, and if he wishes to get out, there is nothing unfair about calling it a closed transaction. If one house is exchanged for another it is, or should be, equally clear that the owner is not through with real estate; he evidences his intention to continue his investment therein and he should not be required to account for the exchange as if it were a closed transaction.

The exchange of a patent for stock of a corporation which owns the patent is not a closed transaction, and the Treasury's position in so holding is not logical, nor is it likely that the position will be upheld by the courts. To impute a profit to such an exchange is to tax paper profits instead of actual profits—Bureau-of-Internal-Revenue-income instead of income as defined by the courts.

The property received must be readily convertible, on a fair basis, into cash, or it is not the equivalent of cash. The courts have held that the sale of a small part of the stock of a corporation need not be used as a criterion of the value of the unsold stock.

The opinion of the United States Supreme Court in

*Eisner v. Macomber* [3] contains a good test. In that case the property received was additional common stock. An attempt was made to tax those who received but who did not sell their stock and who wished to hold it as a continuing investment. The Court said, in effect, that no tax should be levied, payable to the government in cash, unless there was available cash to pay the tax; that obviously the taxpayer would have to sell at least part of the stock to pay the tax, and to compel him to do so when he was virtually in the same position after as before he received the additional stock would be inequitable; and that no tax could be assessed until the taxpayer, by his own act, made a closed transaction out of it.

The Bureau's rule regarding closed transactions has resulted in precisely the same kind of hardship which the United States Supreme Court held was not justified. Inventors who have owned nothing but stock in companies to which the patents were transferred and who could not possibly sell their stock at a fair price, or, in some cases, at any price at all, nevertheless have been assessed enormous taxes on alleged profits or income which was and could not have been realized.

To sum up: a taxpayer should not be permitted to evade the tax on completed transactions by stipulating that the purchase price of property disposed of should be paid in readily marketable property, such as stock exchange securities, and then claiming that such securities were not the equivalent of cash. But when property received in exchange for other property cannot readily be converted into cash except at a sacrifice, and the taxpayer so states under oath, and the Treasury nevertheless attempts to assess a tax thereon, the Treasury should be required to prove that *all* of the property received could have been converted into cash at or about the time of its receipt at a loss in realization of not over 1 per cent. If the Bureau cannot so prove, the taxpayer should be deemed to have received property not the equivalent of cash. If it should so prove, the taxpayer should be assessed and heavily penalized for having made a false return.

[3] *Cf. supra*, p. 116.

In all cases where a transaction is deemed not to be a closed one, and the new property is considered as merely a replacement of the old, on final disposition of the new property, gain or loss will be determined on the basis of the original cost of the old property, or if acquired prior to March 1, 1913, its fair value on that date.

If the so-called new property produces more net income than the old, the Government will receive additional taxes on such increase, and no more should be demanded.

An inventor in 1913 transferred his patents to a corporation in exchange for its stock. A few shares of the stock were sold by the corporation at a small price to raise working capital. It was held that the inventor realized a profit computed by valuing all of his stock at the same price as that which sold. The tax rate was not high in 1913, but the inventor did not sell any of his own stock for cash as he wished to retain control. Even the small tax would have been a hardship as he merely continued his ownership of the patents in a different form. In 1916 the stock of the old company was exchanged for stock of a new company, the transaction being merely a reorganization. The inventor retained control. It is proposed to tax him very heavily as of 1916 on an alleged profit derived from the exchange. The inventor did not sell any of his own stock because he would have lost control if he had done so. Furthermore, if the inventor had started to sell, the market for the stock would have disappeared.

In 1917 the stock of the second corporation was exchanged for stock of another corporation and other properties were acquired by the new corporation. The inventor received some cash but chiefly stock which he was not permitted to sell for six months and at the end of six months he tried to but could not sell. It is proposed to tax the inventor on a large alleged profit as of 1917, although the new company has recently gone into the hands of a receiver and the stock cannot be sold at any price. The inventor did not report any profit in 1913, 1916 or 1917. If he had he could not have paid the tax thereon. If the present proposed tax is upheld he will be unable to pay and he will be ruined. He has no

recourse to the courts as collectors cannot be enjoined from collecting a tax no matter how illegal or excessive the assessment may be.

The Income Tax Section of the Bureau of Internal Revenue holds that the sale of a few shares of stock is a sufficient criterion to impute a market value to an entire issue even though evidence is submitted that only a few shares were offered for sale. This position is taken because it helps bolster up the fiction of a closed transaction.

On the other hand, when the sale of a few shares of stock at a low price helps a corporation in connection with the capital stock tax, another section of the Bureau repudiates the claim that such sales are representative. The following is an official statement made in November, 1920:

> The value desired for the purpose of this tax is the net value back of the entire capital stock of a going concern. The value reflected by the sales of shares of stock cannot be accepted as representative of the fair value of the total outstanding stock, as the sales reported are few in comparison with the total number of shares.
>
> The price paid for the stock so traded in on the stock exchange does not in all cases indicate the fair value of the total stock, as has been clearly proved in the last six months by the wide fluctuations in stocks commonly known as standard investments. The investors or purchasers on the stock exchange buy the stocks by reason of their desirability from a speculative view as a commodity and are not governed by the value back of the stocks or their earning capacities.

In order to collect a tax on closed transactions and a tax on the fair value of capital stock an old rule is adopted, viz: "Heads I win, tails you lose." A business house which tried to adopt this rule would be considered to be dishonest.

In 1916 The General Motors Co. of New Jersey caused to be organized The General Motors Co. of Delaware. To the latter were transferred *en bloc* all the assets of the New Jersey company. Five shares of Delaware Company common stock were exchanged for one share of New Jersey company common stock. With the exception of a few cents differential in the preferred stock transfer, the holder of the Delaware stock had nothing new but a different piece of paper. The assets and earnings were the same. In fact, many stockholders did not make the exchange in 1916 as one share of the old

common continued to sell for the same price as five shares of the new. Any stockholder who desired to retain his investment in The General Motors Co. intact could not have done so if he had reported the transaction as a closed one, unless he could have paid the resulting tax from other sources of revenue. The majority owner of the stock would have lost control if he had been taxed on the apparent profit, and if he had tried to sell, in order to get the money to pay the tax on his profit, the market would have broken and there would have been no profit. The Treasury's position leads to a *reductio ad absurdum* in this, as in some other matters.

The case is analogous to the stock dividend decision wherein it is held that to require a majority holder of a corporation, which makes a change in its form but none in substance, to lose his control although he desires to continue his interest in the same property, would be an unnecessary hardship, and one for which no authority exists under the Sixteenth Amendment.

The only logical solution of the present mess is for the Treasury to rule that when property is paid in for stock of a corporation, or stock was exchanged for stock prior to 1918, and the new stock represented the same assets as the old property or stock, the exchange was a continuing and not a closed transaction.

There is unanimity of opinion in one respect, *viz*, the term "equivalent of cash" has not yet been satisfactorily defined by the Treasury. Frequently the intention of the framers of a law is helpful when ambiguity exists. The *Congressional Record* sheds some light on this point. From the questions and answers regarding section 202 it is obvious that during the debate in the House of Representatives, Mr. Kitchin who introduced the bill, and others who were most prominently identified with it, were not in much doubt. The following question and answer [4] should be considered as authoritative because no dissent from the answer was made:

Mr. HARDY. If "A" and "B," owning two tracts of land, exchange those tracts without any money being paid, although each one of

[4] *Congressional Record*, September 16, 1918, pp. 10351–10352.

them has enhanced in value, is there any tax on that exchange?

Mr. FORDNEY. No. They have received nothing. They have had no income. You do not have an income until you convert the property into money. I may own a piece of land and exchange with you for another piece of land today worth twice what the property cost me when I gave it to you, but there is no income, because I have not converted it into money.

In view of the foregoing, existing regulations do not appear to be fair interpretations of the law.

It may fairly be said that the tendency of the courts is to permit taxpayers to withhold the return of income until there is a definite realization in money, or in some thing so near to what most people look upon as money that no taxpayer will be embarrassed in finding the funds to pay the tax. In other words we can count upon a liberal interpretation of the terms "equivalent of cash" and "fair market value." In reaching this conclusion I do not rely upon the decisions of the courts in the cases of *Maryland Casualty Co. v. U. S.*[5] and *Doyle v. Mitchell Bros. Co.*[6] In those cases the courts intimated that cash receipts rather than accruals must be considered in arriving at taxable income, but both cases were brought under the federal corporation tax of 1909 which was an excise and not an income tax. As an excise tax the Attorney General consistently and quite properly took the position in his official opinions that taxpayers would have to make up their returns on a cash basis. But in practice the Treasury never attempted to enforce a cash basis. Blanks were sent out which called for a return of net income on an accrual basis. As this was the only sensible thing to do and as taxpayers desired to prepare their returns on an accrual basis practically no one questioned the irregular action of the Treasury. But when a taxpayer questioned the authority of the Treasury and invoked the law, the courts naturally gave consideration to its very clear intent, and as the intent of the law was clearly contrary to an accrual basis the cash basis appeared to be and was sustained.

I read in most of the decisions of the courts under the 1913

[5] 52 Ct. Cl. 201.

[6] 247 U. S. 179.

and subsequent laws definitions of income which agree with the understanding of most taxpayers. The chief trouble is with the regulations and the practice of the Treasury.

In such cases as the instalment business the accrual method may be ignored (even though perhaps all instalment houses keep their books under the accrual method), and a cash basis, for which I find no warrant in the law, may be substituted.

In the case of inventors and others who exchange property for shares of stock, or investors who exchange stock of a corporation incorporated in one state for stock of the same corporation—(with the same assets and the same liabilities) incorporated in another state, the accrual method is imposed. In the former case taxpayers who have no special claim for relief are tremendously benefited, while in the latter case taxpayers are actually threatened with financial ruin.

I repeat that the solution is not a difficult one. All that is required is a reasonable interpretation of the terms "equivalent of cash" and "fair market value."

Prior to the enactment of the 1918 law there was no distinction in the law itself between the exchange of various classes of property. The law broadly taxed the gain or income "derived from the sale or other disposition of property." There must have been a gain "derived" before the tax could be assessed. Obviously the law could not tax anything except income, so that the word "derived" could be no broader than the word "income."

In order to *limit* or *prevent* the taxation of unrealized gains there was a strong trend in Congress, at the time the 1918 law was being written, towards stating in specific words that no tax would be imposed when property was exchanged for stock.

The Senate draft of the reorganization section of the 1918 law was as follows:

> . . . or when a person or persons owning property receive in exchange for such property stock of a corporation formed to take over such property, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

It was felt, however, that the Senate draft was too liberal and that ways might be devised to escape tax in cases where income was clearly realized. Instead of defining what was meant, Congress passed the following:

*When Par Value of New Securities Is Greater.*

Law. Section 202. (*b*) . . . When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock or securities exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.

The foregoing section of the law is difficult of interpretation. In this case the conflicting intentions of the legislators produced an unsatisfactory result.

It will be noted that the new matter (which was inserted by the conferees of the Senate and House) attempts, as a maximum, to impose a tax upon the *excess* of the par value of the new securities over the aggregate par of the old. Under the Senate bill no tax at all would have been imposed upon former owners who retained stock in corporations formed to take over their property. The compromise was not intended unduly to penalize such persons, but its exact import will probably never be known.

The part of the section dealing with the excess of par value has been interpreted to mean that in no case shall the gain upon which the former owner is to be taxed exceed the amount by which the aggregate new par exceeds the aggregate old par. If stock having par of $10,000 (the fair market value of which is $1,000,000) is exchanged for stock having new par of $100,000 (fair market value of $1,000,000), the gain is deemed to be $90,000 and not $990,000. But if stock having par of $100,000 (the fair market value of which on March 1, 1913, was $150,000) is exchanged for new stock having par of $200,000 (the fair market value being $200,000) the gain is deemed to be $50,000 and not $100,000.

The regulation confirming the foregoing statement follows:

Regulation. If in the case of any reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock and securities exchanged, income will be realized from the transaction by the recipients of the new stock or securities to an amount limited by (*a*) the excess of the par or face value of the new stock or securities over the par or face value of the old and (*b*) the excess of the fair market value of the new stock or securities over the cost or fair market value as of March 1, 1913, of the old. In other words, the taxable profit will be (*a*) or (*b*), whichever is less. Upon a subsequent sale of the new stock or securities their cost to the taxpayer will be the cost or fair market value as of March 1, 1913, of the old stock and securities, plus the profit taxed on the exchange. (Regulations 45, Art. 1569.).

*When Stock Received Has No Greater Par Value.* Unintentionally perhaps the way was opened to enable taxpayers to take advantage of the plan embodied in the Senate draft in all cases when the par value of the new securities in a reorganization was not material, or, what is more probable, the framers of the bill were all familiar with the trend towards no-par-value securities and it was expected that most reorganizations would not be taxable. Without the slightest possibility of precipitating a tax, any reorganization can go through without making anyone liable to the tax if care is taken to keep down the par value of the new securities. The law thus places a premium upon those reorganizations, mergers and consolidations which otherwise might be held to be closed transactions, but in which payment is made for securities on a basis of the same or smaller par value. In such cases no return whatever is required even though there be an actual or market value of the new shares which is several times the par value.

When a taxpayer exchanges 1,000 shares of stock of a par value of $100 for 100,000 shares of $1 par value in a new corporation, no gain can be deemed to occur even though the cost or value March 1, 1913, of the old stock was $100 per share and the fair market value of the new stock is $10 per share, thus indicating an apparent profit of $900,000. The apparent profit cannot be taxed, as the language and intent of the law are clear and not ambiguous.

It is not a question of why Congress did not tax such transactions: the fact is that it did not do so and did not intend to do so. Logically it may be inferred that there could not possibly have been any intention to tax a similar transaction wherein the exchange was for 100,000 shares of no-par-value stock which at the time of receipt might have an apparent market value of $10 or more.

*When No-Par-Value Stock Is Received.* As stated elsewhere it was originally intended, in writing, the 1918 revenue law, that when capital stock or property was exchanged for capital stock, and the new stock represented the same, or substantially, the same assets, and was issued to the former owners, there would be no taxable profit or deductible loss unless the new stock were disposed of for cash or the equivalent of cash. From the conference compromise there emerged that weird Section 202. It was thought for some time that the chief ambiguity in the section was in the second paragraph of Sub-Section 2 (b) wherein new stock of greater par value is referred to, and that the first paragraph (which in effect says that there shall be no tax when new stock is of no greater par value than the old securities for which it is exchanged) was clear and workable.

In the first edition of Regulations 45 which was issued within a few weeks after the law was passed there was no specific reference in Article 1567 to no par value stock, although for a number of years, and in many states, the practice of issuing stock without par value has met with increasing favor.

Between the original edition of the regulations and the edition of April 17, 1919, there was time to ascertain the intention of Congress and to interpret properly the meaning of the section. Article 1567 was considerably modified and reduced. The principal change which has a direct bearing on the subject under discussion occurs in the last sentence: "If the stock so received has no nominal or par value the limitation on aggregate par value is inapplicable." This was intended and accepted as a reasonable interpretation of the law.

But on June 20, 1919, there was issued a Treasury decision which completely changed Article 1567. The last sentence of

Article 1567, as it appeared in the April 17 edition, was omitted and in substitution therefor the following was added:

> Regulation. . . So-called "no-par-value stock" issued under a statute or statutes which require the corporation to fix in a certificate or on its books of account or otherwise an amount of capital or an amount of stock issued which may not be impaired by the distribution of dividends, will for the purpose of this section be deemed to have a par value representing an aliquot part of such amount, proper account being taken of any preferred stock issued with a preference as to principal. In the case (if any) in which no such amount of capital or issued stock is so required, "no-par-value stock" received in exchange will be regarded for purposes of this section as having in fact no par or face value, and consequently as having "no greater aggregate par or face value" than the stock or securities exchanged therefore. (T.D. 2870, June 20, 1919).

On September 26, 1919, another decision was issued [7] and Article 1567 was further amended, but the amendment did not make any change at all in the part of the article under discussion.

Today no one who tries to comply with the Treasury regulations knows how no-par-value stock should be dealt with.

The reason no one knows is that the obvious intention of the law is disregarded and an attempt is being made to impute to no-par-value stock, market value when it has no market value and also par value when it has no par. When there is a doubt about the meaning of a word, common usage is supposed to control. But in determining whether or not stock has par value we are told to search the statutes of many different states, so that what is called no-par-value stock in one state might be deemed to have a par value of $19.89 if a corporation should reincorporate in another state, and happened to have that amount of net worth back of each share.

It is absurd to think that one taxpayer who receives shares of no-par-value Delaware stock, pays no tax, whereas another taxpayer in precisely the same position as to cost of original property, present worth, etc., and who received no-par-value Pennsylvania stock may have an enormous tax imposed, even though in both cases there is no intention whatever on the part of either taxpayer to dispose of his property.

[7] T. D. 2924.

Space will not permit a full discussion of this point. The law does not appear to be ambiguous. It reads as follows:

Law. Section 202 (*b*) . . . but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

It is not pleasant to differ so radically from the Treasury but it seems probable that the courts will not find the law difficult to interpret. An amendment to the law in the future will not cure its defects, if any. I think that the cure will come from a forced reversal of the Treasury's position rather than from an amendment.

The regulations do not, and probably cannot, define with any degree of finality what is and what is not a reorganization. When physical property is exchanged for shares of stock or shares of stock are exchanged for other shares of stock, the transaction usually is referred to as a reorganization. When the shares received in exchange cover the same, or substantially the same, property as was covered by the property or shares exchanged there is a continuing interest which should not be taxed. It may be, however, that the new shares represent the ownership of radically different assets so that the old owner, instead of continuing his interest, in fact sells out and acquires an interest in a different concern. In the latter case the transaction should be referred to as a sale and not as a reorganization. If the shares received are those of a corporation for whose securities there is a broad market, and the securities received can readily be disposed of without affecting the market, I see no objection to holding that the equivalent of cash has been received.

Another class of transactions is found where the purchase price or consideration arising from the sale or exchange of property is payable over a period of years. Usually in the case of these instalment sales the deferred payments are definite in amount, payable in cash at fixed times and represented by promissory notes. The promissory notes in turn are secured

by collateral and by liens, if they are in the form of chattel mortgages. The Treasury regulations are in part as follows:

Art. 42. Sale of Personal Property on Instalment Plan.—Dealers in personal property ordinarily sell either for cash, or on the personal credit of the buyer, or on the instalment plan. Occasionally a fourth type of sale is met with, in which the buyer makes an initial payment of such a substantial nature (for example, a payment of more than 25 per cent.) that the sale, though involving deferred payments, is not one on the instalment plan. In sales on personal credit, and in the substantial payment type just mentioned, obligations of purchasers are to be regarded as the equivalent of cash, but a different rule applies to sales on the instalment plan. Dealers in personal property who sell on the instalment plan usually adopt one of four ways of protecting themselves in case of default: (*a*) through an agreement that title is to remain in the seller until the buyer has completely performed his part of the transaction; (*b*) by a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price; (*c*) by a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the seller; or (*d*) by conveyance to a trustee pending performance of the contract and subject to its provisions. The general purpose and effect being the same in all of these plans, it is desirable that a uniformly applicable rule be established. The rule prescribed is that in the sale or contract for sale of personal property on the instalment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each instalment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. Such income may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from instalment sales, (such collections being allocated to the year against the sales of which they apply) which the annual gross profit to be realized on the total instalment sales made during each year bears to the gross contract price of all such sales made during that respective year. In any case where the gross profit to be realized on a sale of contract for sale of personal property has been reported as income for the year in which the transaction occurred, and a change is made to the instalment plan of computing net income, no part of any instalment payment received subsequently to the change, representing income previously reported on account of such transaction, should be reported as income for the year in which the instalment payment is received; the intent and purpose of this provision is that where the entire profit from instalment sales has been included in gross income for the year in which the sale was made, no part of the instalment payments received subsequently on account of such previous sales shall again be subject to tax for the year or years in which received. Where the taxpayer makes a change to this method of computing net income his balance sheet should be adjusted conformably. If for any reason the vendee defaults in any of his instalment payments and the

vendor repossesses the property, the entire amount received on instalment payments, less the profit already returned, will be income of the vendor for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself, less proper allowance for damage and use, if any. If the vendor chooses as a matter of consistent practice to treat the obligations of purchasers as the equivalent of cash, such a course is permissible. (T. D. 3082, October 20, 1920.)

From the point of view of a closed transaction the usual instalment sale fulfills all of the requirements except that of payment in full in cash. Most concerns which sell on the instalment plan formerly kept their books on the accrual plan and treated all sales as closed transactions. To cover the unusual losses and expenses of realization, reserves for bad debts were set up so that the accounts for each year accurately reflected the net profit for such year. The only essential differences between the ordinary concern selling on short-time credit and the one selling on long-time credit are that the latter requires a somewhat higher reserve for bad debts, say five per cent. instead of one per cent., and more working capital.

These two items, however, justify no special consideration under any of the federal tax laws, but for some unexplained reason instalment houses have received extraordinary treatment from the Bureau of Internal Revenue. It is held that the sale of a piano for $200 payable in 20 monthly instalments of $10 each (each instalment represented by a negotiable promissory note) is not a closed transaction. The possibility of loss is negligible as a substantial initial cash payment is required and a chattel mortgage is taken, under which the piano may be seized if the payments are not met. Yet the Treasury holds that an inventor who exchanges his patent for the entire stock of corporation, only a few shares of which are sold, is taxable on the exchange as if it were a closed transaction. Probably not once in a hundred times are all of his shares salable at any price and not five times in a hundred is there a strong probability that in subsequent years there will be an opportunity to dispose of the shares for cash. But the instalment concern is permitted to call its sale of a piano an open,

untaxable transaction, with no tax to be assessed unless and until actual cash is received.

It is well known that there is a good market for the promissory notes of instalment houses, although the rate of discount is higher than on short time paper. It is equally well known that there usually is no fair market whatever for the stock of closely-held corporations.

The most recent ruling in respect of instalment sales attempts to justify the present position of the Treasury. If the principle so clearly stated could be depended upon to be the consistent attitude of the Treasury there would not be so much uncertainty about closed transactions. Office Decision 715, appearing in official *Bulletin of Income Tax Rulings*, *45–20*, is as follows:

> In the case of sales of personal property where substantial initial payments are made (more than 25 per cent. of sale price), Article 42 of Regulations 45 provides that obligations of the purchasers are to be regarded as the equivalent of cash. It is recognized that in many sales of this type the obligations of purchasers, even though represented by notes or other paper in negotiable form, cannot be discounted or otherwise converted into cash without material loss because of lack of credit on the part of the buyer and the nature of the property covered by such contracts. The obligations of the purchasers in those cases can scarcely be considered the equivalent of cash in any sense, and it is not contemplated by the regulations that such obligations are required to be so treated. On the other hand, the profits from such sales may be computed in accordance with the rule prescribed in cases of the sale or contract for sale of personal property on the instalment plan, provided, of course, the taxpayer chooses to do so as a matter of consistent practice, and provided a statement is attached to the taxpayer's return disclosing the fact and showing conclusively that the obligations of the purchasers are not the equivalent of cash.

Under the foregoing it is apparent that a showing by a taxpayer that he found promissory notes hard to discount would be accepted as sufficient to postpone the assessment of any tax until the notes were paid in cash.

In these days when tax rates fluctuate violently from year to year, uniformity of treatment with respect to the taxation of realizations is highly important. The owners of two pieces of property appreciating in an identical manner over a period of years may have to pay radically different taxes, depending

upon the particular years when realizations chance to occur. This difference may develop to such serious proportions as to justify an attempt to devise some method of inventory for such property which would result in an annual tax on the appreciation of each person's property at the same rates. Or it may lead to the system of taxation of gains which was adopted regarding dividends received in 1917, *viz.*, the apportionment of part of the gain to previous years and the application of the tax rates in force in those years.

It may be necessary to apportion the gain ratably over the previous years and thus work certain inequities, but in most cases the prorating system would spread the surtax and thus remove the chief criticism of a tax law which imposes in one year a graduated tax upon a gain which may have been accruing since 1913. While the present situation continues, it would seem wise to avoid as many opportunities for injustice as possible by making sure that the tax is levied only in cases which are undeniably realizations.

It might be urged that if a taxpayer were permitted to continue to exchange or trade securities without being required to report such transactions for income tax, he might in the course of time run up a "shoe-string" to a million dollars without having paid a cent of tax thereon. This is, of course, true, but such a person would be in no more favorable a position than the person whose property appreciates to a like degree without being exchanged back and forth from hand to hand. The truth is that there is no logical stopping point between the policy of taxing no capital gains at all and the policy of taxing everyone's capital gains periodically upon the basis of an inventory. The present law essays a compromise and attempts to tax gains when the property exchanged has a "fair market value." I contend that this value should be something more definite than a guess or even a value imputed from an occasional market quotation for similar property. The tax should rest upon a substantial foundation.

It is not suggested that the Treasury should have the power to enforce the inventory method as it would result in a tax on unrealized appreciation, but if a taxpayer desires voluntarily

to adopt such a method there could be no valid reason against it.

At present the realization of a substantial profit from the sale of property which has been held for a period of years carries with it an almost prohibitive tax, and it is argued that that many business transactions, ordinarily desirable for the proper conduct of business, are on this account not consummated.

Probably the best plan would be to permit the prorating of the profit over the years during which the property was held. This plan has many supporters, including the Secretary of the Treasury, and it is probable that the law will be amended to give effect thereto. It must be remembered, however, that the rate of tax and the spreading of the tax over a period of years have no direct relation to the question "when is a transaction a closed one?"

# LOSS AS A FACTOR IN THE DETERMINATION OF INCOME

## Depreciation, Obsolescence, Amortization and Losses Due to Casualties or Theft

BY

George E. Holmes

Our present federal income tax system is devised according to a concept of income different from that underlying any former system in this country and, perhaps, different from that in the minds of the legislators of any other country—certainly different from that according to which the British system of income taxation was built up.

Income may be regarded as the fruit of a tree called capital.[1] The fruit would be interest, dividends, rents, royalties, trading profits, *et cetera*. This appears to have been our notion of income in the taxing statutes of the Civil War period and it seems to be the same in Great Britain. In our present system, comprising all the acts passed since the Sixteenth Amendment to the Constitution, the notion is that not only should the taxpayer be taxed on the annual fruit which his tree of capital bears, but also upon the growth of the tree itself—the enlargement of the trunk and branches, and the new branches which have sprouted during the year. One difficulty we have is to measure this growth of capital; it may be so imperceptible or so indefinite as to be incapable of measurement annually, and, therefore, the statute provides that the increase in capital shall not be taxed until the increase can be definitely measured in terms of money, by reason of a sale or exchange.

[1] This picturesque anaology was used by the Supreme Court of Georgia in Waring *v.* Savannah, 60 Ga. 100. *Cf. Supra, p. 10 et seg.*

Stated in another way, our federal tax is imposed on taxpayers in accordance with their ability to pay; and this in turn is measured by the taxpayer's annual increase in net worth, from all sources, so far as it can be measured in terms of money.

Since we take into consideration the growth of the tree, as well as the fruit thereof, in calculating net income, we must also carefully consider the damage done to the tree during the year, for it would not be feasible to go on taxing the new growth and ignoring the damage to the old growth. On the other hand, if we ignored the growth of the tree and taxed only the annual fruit which it yielded, we would find it unnecessary to pay so much attention to the damage suffered by the tree. This illustrates one great difference between our tax system and the British system. We tax capital gains and allow for capital losses; the British do not tax capital gains and, generally speaking, ignore capital losses.

Capital losses, other than those incurred in sales, may be divided into two general classes: (*a*) those which take place completely within the tax year and can be measured at the time they take place, such as losses arising from fire or other casualties or from theft, and (*b*) the more gradual and less perceptible losses which take place through depreciation or obsolescence of an asset used in producing income. There is a third and most extraordinary loss, provision for which is made in the Revenue Act of 1918, generally called the amortization of war facilities. These various losses will be discussed in the order of their general interest to taxpayers.

## Depreciation

In its broad sense depreciation means, by derivation and common usage, a fall in value; a reduction of worth.[2] But the word is not used in this broad sense when we refer to depreciation in connection with income taxes. In fact, only one of the statutes in our present system of income taxation,

[2] New York Life Ins. Co. *v.* Anderson, 263 Fed. 527.

*i. e.*, those statutes passed in 1913 and thereafter, uses the term "depreciation."

The Act of August 6, 1909, which was not a true income tax law,[3] did provide for "a reasonable allowance for depreciation of property," and under that law it was permitted to take into consideration loss in market value. Corporations were permitted to mark their investments down—or up—according to market prices, and to reflect the result in the calculation of that statutory net income by which the tax was measured.

That, however, is not permitted under the income tax statutes passed since the adoption of the Sixteenth Amendment. The allowance for depreciation is clearly defined as "a reasonable allowance for exhaustion, wear and tear of property" or, in one provision only, "a reasonable allowance for depreciation by use, wear and tear of property."

*Kind of Property Subject to Depreciation.* The property on which depreciation may be claimed must be used or employed in the business or trade of the taxpayer. Trade or business in this sense may be broadly interpreted to mean any activity from which taxable income arises. It excludes a taxpayer's residence, because that is not employed in his business or trade, and any loss thereon through depreciation is considered a personal or living expense. But it would include residential property from which a taxpayer derives income, for then the building is considered to be employed in trade or business. It would not include an idle building merely held for speculation or investment; any loss through deterioration would be reflected in the selling price. It does not include land itself, for that is not susceptible of wear and tear or exhaustion. In certain cases, however, depreciation may be claimed with respect to the capital used to prepare land for certain commercial purposes. For example, if an orchard is planted for commercial exploitation it may happen that a large investment is necessary in order to plant the trees, and these trees may have a definite life beyond which there will be no income yield. In such cases the original cost of planting and the cost

[3] This Act imposed an excise tax on corporations for the privilege of doing business, the tax being measured by "net income" as defined in the statute.

of development up to the point of fruit-bearing may be capitalized and the capital investment depreciated over the income-producing years of the trees. Ordinarily, perhaps, the cost of planting and caretaking is charged to expense in the years in which the expenditures are made, in which case no depreciation is chargeable. Again, in sugar plantations great expense may be incurred in preparing the land and setting the plants. Notwithstanding a consistent replanting to take the place of dead plants, the whole plantation must be re-worked and replanted after a certain number of years. The cost of this work may be capitalized and depreciation taken over the fruitful life of the crop.

With respect to mineral-bearing lands and timber, special rules are formulated under that provision of the law which allows depletion, a subject to be treated elsewhere and which, therefore, will not be dwelt upon here.

Any property used in a taxpayer's business may be depreciated, even clothes, such as the costumes of an actor, but nothing used for the taxpayer's pleasure or personal comfort is a subject of depreciation. An automobile chiefly used for pleasure is excluded, but one used for business is included. In case of doubt the taxpayer must show a reasonable need for the property in his trade or business, otherwise the presumption is against the allowance of the claim for depreciation.

Depreciation does not apply to things bought by the taxpayer for resale, but is intended to apply to things used by him to produce income and which wear out or become exhausted in the course of such use. Therefore, inventories of stock in trade cannot be depreciated. Any deterioration therein may be allowed for only in accordance with the rules relating to inventories.

Machinery, buildings and similar tangible property are most generally thought of in connection with depreciation. Depreciation by wear and tear is most marked in machinery and, it seems, the theory of allowing depreciation first grew up around the problem of how properly to prepare for the purchase of a new machine when the old was worn out. Under our present law, depreciation is not limited to the exhaustion,

wear and tear of physical property only; it includes intangible property as well. The intangible property, however, must be such as has a use in the trade or business for a definitely limited period. Patents, copyrights, licenses and franchises may be good examples. Goodwill, trade-marks and brands are not considered subject to exhaustion or wear and tear, and there is no general way to measure definitely the time when they will cease to be useful in the business. Therefore, depreciation cannot apply, although obsolescence may, under exceptional circumstances. The test as to whether or not an intangible asset can be depreciated for purpose of the tax may often be found in the question "Can the useful life of this asset be accurately and definitely determined?" If not, there is no measure by which an allowance can be ascertained, and although the asset may gradually disappear, accounting therefor must await some occasion when definite determination, by way of sale or otherwise, fixes the amount of the taxpayer's loss.

*The Value Which May Be Provided for by Depreciation.* Having regarded the various kinds of property which depreciate for income tax purposes, we will consider the amount which in the aggregate may be deducted as depreciation with respect to a particular asset.

The underlying theory of depreciation is that the taxpayer shall be allowed to set aside such sums annually as in the aggregate will equal his capital investment in the property and that such sums shall be free from tax, for to tax them would be to tax his capital. Receipts must necessarily be divided into two parts—one, the return of capital, and the other, profit or income. We have this problem in all cases of receipts, except purely compensation for personal services. On sales we deduct the cost of the goods sold. When we have thereby reached a taxpayer's gross income, we deduct his legitimate business expenses. The deduction for depreciation is one of these and is simply spreading over a number of years the cost of property which disappears in use while creating goods or services that produce income. If a taxpayer accounted for net income only once in a lifetime, and sold all his assets

for cash before so doing, we would not have any problem of depreciation, for the final sale would determine with absolute accuracy what his profit had been, assuming a correct account of actual receipts and disbursements had been kept. But we have an accounting for tax purposes each year, and it is in the interest of the accuracy of this yearly accounting that we calculate the annual depreciation.

The capital of a taxpaper represented by any particular asset may be one of two things: (*a*) the value of that asset on February 28, 1913, or (*b*) its cost if acquired after that date. The former is an artificial measure of capital due to the limitation on the power of Congress to tax income which accrued prior to the adoption of the Sixteenth Amendment to the Constitution; the latter is the natural capital investment.

To ascertain the value on March 1, 1913, is often a difficult problem. It is a question of fact and subject to all the uncertainty of such a question. In the absence of proof to the contrary, the value on that date will be presumed to be the original cost less depreciation. But if it can be shown that the particular asset in fact increased in value the taxpayer is entitled to take the fair market value on March 1, 1913, as the basis of depreciation thereafter. Conversely, if it appears that the value of the property was less than cost minus depreciation, the lower value must be adopted. As a general rule, no change in value is asserted by the taxpayer, but occasionally, and especially in the case of patents, the fair market value on March 1, 1913, can be shown to have been much greater than the cost.

The cost of property is generally a fact simple of ascertainment. It includes the amount paid for the property originally plus any subsequent expenditures for improvements, additions and betterments and carrying charges, provided the cost thereof was not deductible as an expense in the year when the expenditure was made. The capital invested in an asset, which would normally be subject to depreciation, may be reduced by loss or damage to the property or by sale of a part thereof, in which cases the depreciation basis must be

adjusted. If it is borne in mind that by depreciation allowances the taxpayer is presumed to have returned to him his capital outlay in a series of fair annual allowances which will amount to the total capital outlay at or about the time the property is worn out or exhausted, many of the problems become easy of solution.

One difficulty in determining cost arises where a lump sum is paid for an aggregate of depreciable and non-depreciable property, as for instance, where land and buildings together are purchased. In such cases the respective values of the depreciable and non-depreciable property must be determined in order to find the proper basis for depreciation. Such segregation is a question of fact and no general rules can be laid down.

Another difficulty arises where the consideration paid for the property is in some other form than cash. In the case where the transfer of property is made to a corporation the consideration is frequently either stock of the corporation or its bonds. In such cases the "cost" to the corporation which may be depreciated is the fair cash value of the stock or other securities issued therefor, provided such stock or securities have a market value. In the absence of a market value the amount to be set up for purpose of depreciation should be the fair cash value of the property at the time of its acquisition by the corporation. Similarly, on the formation of a partnership the basis for depreciation is the fair cash value of the property at the time the partnership is entered into. Where a *bona fide* gift is made or property is acquired by bequest, devise or descent, the value of the property when acquired by the donee or beneficiary is the basis of depreciation to him.

In all cases the investment in the property should be reduced by the estimated salvage or junk value of the asset at the close of its useful life.

*Measure of Annual Depreciation Allowance.* The law expressly specifies that the annual allowance for depreciation shall be "reasonable." A reasonable allowance is usually considered to be that amount which is found by dividing the

cost into as many parts as the property has years of useful life and deducting one part each year. This requires, first, a determination of the useful life of the property. It is considered impracticable by the Treasury to prescribe fixed definite rates of depreciation which should be allowable for all property of a given class or character, since many factors may intervene to vary the period of useful life. The rate at which property depreciates may depend upon its locality, the purpose for which it is used, and the conditions under which it is used and the care given to its preservation. The same kind of a building may depreciate more rapidly in Portland, Maine, than in Los Angeles, California; and so the same rate need not necessarily be applied to two buildings identical in all respects except as to location. Similarly, manufacturing plants in the same locality, doing identically the same kind of business, may deteriorate unequally, due in large measure to the management and to the care with which repairs are made and the property maintained. Many other elements enter into the question, the effect of which can be determined only by particular consideration and often only approximately. The taxpayer must, therefore, use his best judgment and experience in determining the rate at which his property depreciates, and his judgment will be subject to the approval of the Commissioner. Recognizing these facts, the Commissioner will not impute negligence or intent to defraud in a case where a taxpayer charges off a greater depreciation than deemed reasonable by the Commissioner, unless, of course, the position taken by the taxpayer is so unreasonable as to indicate either gross carelessness or bad faith.

The rate of depreciation may vary at different times with respect to the same property. For instance, a building put to one use may suffer comparatively low depreciation, and if put to a different use under which greater strain is experienced, the depreciation rate may justifiably be increased. Again, a machine under normal conditions may be entitled to a lower rate of depreciation than when operated overtime or at an overload. It does not follow necessarily that if a

machine, operating normally for eight hours a day, is operated for sixteen hours a day, it will depreciate twice as rapidly as when operated under normal conditions, but undoubtedly depreciation is accelerated. No general rule can be laid down to gauge the accelerated depreciation, and each case must be determined according to its particular facts.

While the time element is ordinarily used to ascertain the rate of depreciation, in some instances a better measure may be available. For example, where it is definitely known that a particular machine is capable of producing only a definite number of articles during its useful life, the cost may be divided by such aggregate number of articles, and the depreciation taken in any one year is then determined by multiplying the number of articles produced in that year by the depreciation rate so ascertained. Thus the depreciation is made to fluctuate from year to year in proportion to the activity of the machine.

Again, if a machine is useful only in connection with an operation, such as drilling oil wells or perhaps carrying on lumber operations in remote districts, in which the work to be done will terminate before the property used in such work is actually worn out, depreciation may be claimed upon its useful life in connection with the particular operation. In such cases, of course, the amount to be wiped out by depreciation is the cost less the estimated salvage value of the property after the particular operation is completed.

It is seen, therefore, that the depreciation rate is not a fixed conventional rate, but varies with the circumstances of each particular case and may vary from year to year with respect to any particular property. By reason of the difficulty of estimating accurately the rate of depreciation to be applied, it may be found that when the property is finally discarded or sold the sum of the depreciation deductions actually claimed and the salvage value may not be equal to the original cost of the property. As a general rule, if such sum is less than the cost, the difference may be deducted as a loss in the year in which the property is disposed of; if such sum exceeds the cost, the excess must be reported as income in the year in

which the property is disposed of. But where the depreciation charged off has been unreasonably large—or unreasonably small—so as to indicate negligence, carelessness, or fraud on the part of the taxpayer, the Commissioner may require the depreciation deductions for past years to be corrected by means of amended returns in order to arrive at true calculations of net income for each of the several years. It may be noted, parenthetically, that if our tax rates were less subject to change from year to year, it would be comparatively unimportant whether or not too much or too little depreciation was taken in any particular year, since the aggregate amount would be equalized over a long period of time without any material difference in the total amount of tax paid by the taxpayer. However since we have had violent variations in tax rates year after year during the war period, it has become important to determine accurately the precise amount of depreciation properly allocated to each year. For example, many properties were sold in 1917 and 1918 at extremely high prices; if the depreciation claimed with respect to such properties in prior years had been inordinately small, the profit on the sale of the property would be correspondingly low, to the detriment of the revenue; and on the other hand, if the depreciation charged in prior years had been too high, the profit on the sale would have been inordinately high, to the detriment of the taxpayer in a year when rates were excessive. In such extraordinary cases a readjustment of the depreciation actually claimed might be necessary or desirable equitably to determine the amount of income for tax purposes for each of the years, in some of which the rates were low and in others, high.

It appears at times that a mistake has been made in the estimate of the useful life of a property, or in its cost, in which cases the taxpayer is privileged to readjust his depreciation allowance for the future on the correct basis, subject, of course, to the approval of the Commissioner of Internal Revenue.

Office buildings, steamships, *et cetera*, are examples of properties which are of complex character having many parts, some long lived and others short lived. In such cases the various elements of the property, such as the building itself or

the hull of a ship, the machinery or power plants, etc., may be depreciated separately at varying rates, or a composite rate for the whole may be built up by taking into consideration the relative values of each kind of property in relation to the whole cost. The method of arriving at composite rates of depreciation is admirably illustrated, as applied to oil refineries, in the so-called *Manual for the Oil and Gas Industry*, prepared by the Treasury.

Some doubt still lingers about the point of time when depreciation commences, particularly where the erection of a building or plant requires much time. The proper rule, under such circumstances, seems to be that deduction for depreciation should commence in the year when the building or other property is put into active use.

Many authorities on depreciation advocate methods other than the straight-line method of depreciation used by the Treasury, but no other method has received recognition. In the straight-line method the rate is applied to the prime cost each year. There is, on the other hand, much to be said for claiming depreciation on a diminishing balance of investment, for example, ten per cent. upon the cost of the property in the first year; ten per cent. upon the unextinguished capital, being ninety per cent. of the total cost, for the second year; ten per cent. upon the unextinguished balance, or eighty per cent. of the cost, for the third year, and so on. This cumulates a depreciation allowance in the early years of the life of the property, when its earning power is likely to be at its maximum and the expenditures for repairs at the minimum. While there is much to be said for this method of measuring depreciation, it is not recognized for the purpose of our Federal taxes.

*Incidental Repairs to Property on Which Depreciation Is Claimed.* The useful life of a property is not the number of years it will last without repair or attention. It is presumed that a certain amount of ordinary repairs will be made from time to time to keep the property in good condition and to prevent deterioration. The cost of such repairs is a proper annual expense. It may be difficult to distinguish between incidental repairs and such repairs as in effect cause a renewal

or addition to the property. There is always an indistinct line of demarcation, but the comparative triviality or temporary character of the repair is often the best indication that the expenditure is properly chargeable to expense.

Closely related to the subject of repairs is that of renewals. It is possible that worn out parts of a machine or similar equipment may be renewed one after another until the original machine or equipment is swallowed up in renewed parts. The machine or equipment is then in as good operating condition as it was originally, or at least its life has been materially increased. In such cases if the cost of the renewed part is customarily charged to operating expense, no deduction on account of depreciation should be claimed as to the machine or equipment; on the other hand, if a reserve is set up to cover property which may be renewed or restored by parts until the whole is renewed, the cost of the renewed part should be charged to the depreciation reserve fund and not to expense.

In determining the rate of depreciation, attention must therefore be given to the custom or practice followed in making repairs and replacements.

*Additions and Betterments.* Amounts expended in additions and betterments or for fixtures which constitute an increase in capital investment and add to the value of the asset are not a proper deduction as expense, but should be added to the capital investment to which the depreciation rate is applied. A substantial addition or betterment may require an adjustment of the rate to the extent that the useful life of the property is affected.

*Treatment of Excessive or Inadequate Deductions for Depreciation.* It is a well recognized fact that many conservative business men have followed the practice of writing off heavy deductions for depreciation. Others have disregarded depreciation in their annual balance sheets. Consequently the capital investment shown on the balance sheet does not always reflect the true cost less normal depreciation. In order to arrive at the real invested capital for purpose of the excess-profits tax, it is necessary to reconstruct the depreciation reserve account either by setting up a proper reserve

where inadequate depreciation had been taken or to reduce the reserve and thereby increase the surplus account where excessive depreciation had been charged off. This is done on the theory that a true surplus is affected by those constantly occurring losses covered by depreciation. A depreciation reserve, of course, is not included as a part of the invested capital since it is offset by a corresponding loss in the value of the assets in respect to which the reserve is set up.

Where depreciation has been claimed on the value as of February 28, 1913, the depreciation reserve may contain an element of appreciation which took place prior to that date. To illustrate: Property which cost $1,000 in 1912 and which under normal conditions would have depreciated to $900 by March 1, 1913, may in fact on that date be worth $1,800. The taxpayer is therefore entitled to set up $1,800 as his capital invested in such property and to claim depreciation on that sum thereafter. Of such depreciation allowances, one-half, measuring the original unextinguished cost of the property on March 1, 1913, is disregarded in computing invested capital, but the remaining one-half, representing the appreciation in value prior to March 1, 1913, may be added to invested capital and treated as earned surplus. The reason for this is apparent on a moment's reflection. The increase in value between the date of acquisition and March 1, 1913, is gain or profit not subject to tax under our income tax laws. That gain or profit is realized from year to year through the depreciation account, and, therefore, while it is not a taxable profit, it is an earning retained in the business and therefore properly included as an earned surplus.

Bookkeeping entries do not necessarily determine the amount of taxable income or the amount of assets of a corporation, or the reduction in value of property due to exhaustion, wear or tear, but all of these are matters of actual fact to be given consideration, whether or not evidenced by book entries. As a condition to allowing the taxpayer the benefit of depreciation deductions, the Government may, and does, however, require proper records to be kept in the books of account in such manner that the result will be reflected in the taxpayer's

annual balance sheet. The depreciation allowance should be computed and charged off with express reference to specific items, units or groups of property, and the taxpayer should keep such records as may be readily verified. This does not mean, necessarily, that the proper bookkeeping entries must have been made in the year in which depreciation was sustained. The taxpayer may re-open his books, make proper adjustments, file an amended return and show the proper amount of net income. If an adjustment is made for past years, proper adjusting entries may be made in the year in which proper depreciation allowance is finally determined, and such entry will be sufficient to warrant the Commissioner in allowing the corresponding adjustment in taxes.

*Depreciation Reserves.* The subject of depreciation reserves has been clarified by considerable discussion since the passage of the first income tax act in 1913. Originally the Treasury Department took the position that such reserves must be represented by liquid assets to be held until the replacement of a particular property became necessary. The present rule, however, is that the amounts allowed for depreciation may be invested in any property at the pleasure of the taxpayer. It may not, however, be distributed to the stockholders until all of the earnings of the corporation accrued after March 1, 1913, have first been distributed. A distribution from a reserve for depreciation will be considered as a partial distribution of the capital of a corporation and will constitute taxable income to a stockholder to the extent that the aggregate of amounts so received exceed the cost (or fair market value as of March 1, 1913) of his shares of stock. If a corporation has computed its net income for a taxable period without having made an allowance for depreciation and then distributed the entire net income to its stockholders, so that the books show no surplus or undivided profits, it may reopen its books for the purpose of exercising the privilege of deducting the allowance for depreciation. The corporation is then in a position of having paid out a part of its dividends from the depreciation reserve so constructed, or from capital, to the extent that the amount of dividends exceeds the true

net income; that is, the net income after making the proper charges for depreciation. The stockholders must then amend their returns to show the amount of dividends actually paid from earnings and the amount paid from depreciation reserve or capital; and they will then be taxed accordingly. Naturally the invested capital of the corporation for excess-profits tax purposes will be deemed to have been reduced to the extent of the partial liquidation.

## Obsolescence

Depreciation is the loss due to exhaustion, wear and tear. Obsolescence is the loss due to the necessity of discarding property because it has become inadequate or incapable of being used in competition with more modern and effective things, or because the market for the article it produces will disappear before the producing property is exhausted. Both tangible and intangible property may be subject to obsolescence, but no deduction for tax purposes was specifically recognized by statute until the passage of the 1918 law, which allows, in addition to a deduction for exhaustion, wear and tear of property, "a reasonable allowance for obsolescence." A thing may become obsolescent from either one or two causes:

(*a*) The discovery or invention of some better thing to take its place, which is called obsolescence by supercession, or

(*b*) The disappearance of the market for the thing produced by, or sold under, the obsolescing property.

Illustrations of the first kind of obsolescence are common in every-day life. The horse car gave place to the cable car, the cable car was in turn displaced by the trolley car. In railroads the wooden car was displaced by the steel car. In all of these cases the cars may have had the possibility of long life, but the appearance of a better thing necessitated their displacement.

Before the enactment of the 1918 law, the loss arising from this obsolescence could not be considered by the taxpayer until

the obsolesced property was actually sold or otherwise disposed of. Under the 1918 law, it may be taken into consideration as soon as the new invention points to the certain replacement of the old. For example, if a new type of telephone should be invented so infinitely superior to the one now in use that it would be demanded by all telephone users, the present equipment of the telephone companies would become valueless as soon as the new equipment could be made and installed. A deduction for obsolescence could be based upon an estimate of the time it would take to replace the old device by the new. In the case of buildings, it may be found that a steady change in the character of a neighborhood, or the construction of new and superior buildings, may in the course of a definite period of time render a particular building unfit for its present use. A building used for manufacturing may become useful only as a warehouse. If this can be definitely shown to the satisfaction of the Commissioner, an allowance for obsolescence would be permissible, in addition to an allowance for depreciation. The useful life of a building may not be diminished, but the character of its use may be changed and thereby a substantial part of its value may be lost.

It has been argued that experience shows in certain lines of trade a replacement of machinery every ten years, let us say, but mere past experience will not of itself authorize a deduction for obsolescence. The new thing which will inevitably supersede the present thing must have appeared before the period of obsolescence is measurable. It was ably argued with respect to freight steamers on inland waters that experience had shown that new types of vessels were consistently replacing the old, but the Government nevertheless held that until a new type of steamer appears it will be assumed that the latest type in existence is the ultimate type.

Obsolescence due to the loss of a market is very clearly illustrated in the case of brewers and distillers whose market was destroyed by the passage of the prohibition law. This theory of obsolescence has been applied not only to the physical property of distilleries and breweries, but to vineyards and other industries which depended upon the market for spirits,

wines and beers. It was also applied to such intangible property as goodwill on the ground that the goodwill would disappear with the market at a point of time definitely known as early as January, 1918, when the first indication appeared that the prohibition amendment would be ratified by the requisite number of states. From that time on, the value of the goodwill would obsolesce until its final disappearance when the taxpayer ceased business, and, in any event, not later than January 16, 1920, when prohibition would become effective.

To sustain a claim for deduction for obsolescence of goodwill, it must be shown that the goodwill will be of no value at the close of an approximately definite period, and that the taxpayer will be forced to discontinue the business and be unable to continue in any similar business. Indications that the value of goodwill is lessening from time to time are not sufficient to warrant a claim for obsolescence.

An allowance for obsolescence of goodwill will be made only in connection with such goodwill as is assignable, as distinguished from goodwill attaching to individuals owning or conducting a business, or to the premises at which it is or was conducted; and no allowance for obsolescence will be granted in any case where, in connection with the operation of the business, the goodwill will be valuable in another business after the termination of the business in which the taxpayer is engaged.

The principles of obsolescence are as yet dim and obscure, but the tendency of the Treasury is to allow the benefit freely to taxpayers where the fact of obsolescence can be definitely shown and the point of time of complete disappearance of value can be definitely ascertained. Only property used in the taxpayer's trade or business is subject to this allowance and in general the rules applicable to depreciation extend by analogy to obsolescence.

## Amortization of War Facilities

*Definition and History of Statutory Provision.* The term amortization as here used means provision for meeting a loss

of value of property and facilities acquired expressly for war-time activity resulting from the sudden cessation of that activity.

The 1916 law made no provision, either in the original act or as amended by the Act of October 3, 1917, for the amortization of plants or equipment acquired for or used in the production of articles necessary to carry on the war. The first provision for amortization appears in the Revenue Act of 1918:[4]

> In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous acts of Congress as a deduction in computing net income.

This provision lacks definiteness as to the amount of the capital which may be amortized, except that it states the deduction shall be reasonable. Some light is shed on the intention of Congress by the statement made by Senator Simmons on the floor of the Senate, during the discussion of the bill. In answer to a question, he said:

> I can answer the Senator generally by saying that if by reason of the investment of his profits in an extension of his yards he has constructed a plant which was necessary in time of war to meet the demands which were made upon him at that time for production, but which after the termination of the war has depreciated in value because not needed; in that case, under the amortization provision he will be allowed to amortize to the full extent of the depreciation in value. Of course, if there is salvage he would be allowed to amortize only down to the salvage value.[5]

A consideration of the provision in the light of the circumstances at the time it was adopted leads to the following conclusions:

After our entry into the war an abnormal activity took place. Men actuated by patriotic motives and disregarding

[4] Provision for amortization appeared, however, in the earlier Munitions Tax Act.
[5] *Congressional Record*, February 17, 1919, p. 3774.

sound business judgment entered upon extended enlargement of plants, or the creation of new plants, in order to supply the needs of the country. Production was encouraged everywhere. It was evident that demand for the articles produced would cease or materially diminish when the war ended. Costs were abnormally high and their ordinary effect on business was ignored. Speed was the essence, and adding to the high costs due to inflation were the bonuses for prompt delivery, extra overtime pay and extra charges for rapid transportation. A further deterrent to expansion was the abnormally high war-profits tax. Under ordinary conditions the cost of plant and equipment would be charged off over the useful life of the property. But such conduct would have been ruinous in the case of those who put up plants for the specific purpose of assisting in the carrying on of the war. It was necessary, therefore, to allow the extraordinary cost of special plants and facilities to be charged against the income produced by the extraordinary effort which necessitated their construction before assessing an abnormally high war tax.

Examining the statute with this in mind, it is noted that the act does not apply to any property constructed or acquired before our entry into the war or after the armistice was signed, which, of course, marked the end of the extraordinary demand for means of production.

The kind of property which may be amortized is stated in the statute. It includes buildings, machinery, equipment, or other facilities, for the production of articles contributing to the prosecution of the war, and vessels for the transportation of articles or men contributing to the prosecution of the war. The first test, therefore, is the production of the plant. The statute does not state that the articles should be manufactured for this Government, or that the taxpayer should have operated under a Government contract. Consequently, others may also claim the benefit of the provision if it can be shown the property was used to produce articles contributing to the prosecution of the war. Practically every essential—and some non-essentials—contributed to that purpose, and seemingly the word "article" and the word "contributing" should be

broadly construed to take in every activity where the taxpayer can show his production to have directly or indirectly aided in the success of the Allied cause. The statute does not indicate that the articles should be used in the battle area. Many things used here contributed to the prosecution of the war. In fact, it is difficult to exclude any but the most unessential articles from the broad phrase used in the statute.

It also seems clear that the intent of the statute is that the allowance for amortization shall generally be applied to the income of the year 1918, regardless of when it is finally determined. In some cases, where the war activity ran over into 1919 or the income from that activity was received in 1919, the allowance should be apportioned between the two years.

The measure of the amount of the amortization allowance is more difficult to state. Clearly it is not intended to be the entire cost in every case, for that would leave the taxpayer too well off as a result of his war activity. Senator Simmons said it was the cost less salvage value. The statute provides for a period of three years in which finally to determine the amount of the allowance.

It seems, therefore, that if the taxpayer sells the property at any time within that period, he may deduct the loss from his income for 1918. In calculating the loss, certain unusual facts may perhaps have to be considered, as for instance the loss of interest on the investment up to the time he found a buyer, the extent to which he may have made the property more valuable after the war, by reconstruction or otherwise, in order to obtain a buyer, and many other facts. What should be allowed is limited only by the phrase "reasonable deduction," and within that limit the Commissioner's judgment and discretion would govern.

If that is the procedure in the case of the taxpayer who has sold his property, what should be done in the case of one who could not sell or who elected to use the property to its full capacity or part capacity in post-war activities?

Inability to sell might be caused by inability to find a purchaser. In such case, if the property is discarded and not used in post-war activity, all the investment, less junk value, would

be deductible. If the property is not saleable, by reason of being a part of the taxpayer's old plant, which cannot conveniently be used by another, and the taxpayer has no use for it by the end of the three-year period, it would seem that all except the salvage value would be deductible. If he finds use for it within the three-year period, the value to him would perhaps be deductible from the cost and the remainder amortized.

Cases will no doubt arise where taxpayers find the property of use to them in its full capacity within the three-year period. In such cases a reasonable allowance would probably be the difference between the actual cost and a fair replacement value under stable post-war conditions so far as such conditions are indicated within or foreseen at the close of the three-year period.

Tentative claims for amortization are contemplated by the law and were made by many taxpayers in their returns for the year 1918. The Commissioner made many rulings to control these tentative deductions, some of which were protested by taxpayers generally and modified. The purpose of the Commissioner was, of course, to prevent exorbitant claims from being filed, and it became a matter of much importance to the taxpayer to justify his claim by the best evidence obtainable.

No general rule could be made or method prescribed to indicate the amount which might be claimed tentatively. In any claim made before the close of the three-year period, a part of the claim must necessarily deal with the amortization then determined by sales or other definite measure, and the other part with an amount estimated as likely to occur before normal post-war conditions are reached. The British rule, in this respect, has been to assume, tentatively, that post-war values will be approximately pre-war values and to make adjustments with the taxpayer on that basis, subject to revision and increase of the tax if that assumption proves to be incorrect.

### Losses Due to Casualties and Theft

While our income tax statutes have limited deduction for losses arising from transactions in property to the taxpayer's trade or business, or, under the later laws, to transactions

entered into for profit, and limited deductions for depreciation and obsolescence to property employed in the business, losses arising from fire, storm, shipwreck or other casualty, or from theft, are deductible whether or not the property was used in the business of the taxpayer. This appears to be a departure from the general theory of taxable income. The result is that if a taxpayer's residence is sold at a loss the loss cannot be deducted, but if his residence is destroyed by fire his loss may be deducted. This exception to the general rule is apparently intended to lessen the rigor of the tax in the case of individuals who have had the misfortune to lose capital through causes beyond their control. It should be noted that the loss must be one due to an act beyond the control of the taxpayer.

A loss due to voluntary destruction of the property is not deductible under this head. For example, land may be purchased on which good and substantial buildings exist at the time of the purchase. Naturally the price paid for the property includes the value of such buildings. The purchaser, however, intends to construct a different kind of building on the property and his first step is to demolish and remove the old buildings. The loss resulting from such demolition and removal is not deductible from his income tax, but the entire cost of the property, including the cost of removal of the old buildings, is held to be his capital investment. If, however, old buildings are demolished or old machinery is scrapped in the course of a going business, the deduction of the net amount of the loss to the taxpayer may be made in the year in which the property is discarded. The rules applying in such case are stated in the discussion on depreciation.

The deduction of losses arising from fire, storm, shipwreck, or other casualty or theft, is usually, though not necessarily, limited to physical property,—in the case of non-resident aliens only with respect to property located in the United States, and in the case of foreign corporations only if and to the extent the property is connected with income arising from a source within the United States. In the case of a citizen or resident, or a domestic corporation, the loss may be deducted regardless of where the property is situated.

The year in which the loss may be deducted is still a matter of uncertainty under the statute. In the earlier laws it was provided that a deduction could be had only for losses actually sustained during the year. Under the present statute the word "actually" is omitted, and in many instances it becomes important to determine whether the loss is sustained in the year in which the casualty or theft may actually have happened, or in the year in which it is discovered by the taxpayer, or in the year the precise amount of the loss is finally ascertained. In a recent case, apparently never reported, it was held, under the Corporation Act of 1909, where an embezzlement was discovered several years after it took place, the time of the discovery of the loss bore no relation to the date of the loss. The loss was sustained when the theft occurred, and the taxpayer was not entitled to any deduction in the year in which it was discovered. The rule in the Treasury seems to be that the taxpayer shall reopen his return for the year in which the loss actually took place and amend his statement of net income accordingly. The development of the law on this point, however, has not proceeded so far that definite rules can be laid down applicable to all cases.

The net amount which may be deducted as a loss by a taxpayer is the value of the property on February 28, 1913, or its cost if acquired after that date less proper depreciation to the date of sale, and less also any amount received as compensation by way of insurance, and any salvage value which the property may have. If after this computation has been made it appears that in a subsequent year the taxpayer receives further compensation for the loss by way of insurance or otherwise, such compensation is not income in the year in which it is received, but should be applied to a reduction of the loss in the year in which the loss was sustained. This may not, however, be a definite rule in all cases, and perhaps may be cited only as an indication of the lines of development of this point of the law.

# INVENTORIES

BY

ARTHUR A. BALLANTINE

Until recently inventories were not the subject of much theoretical discussion. They were handled by practical men in a practical way. Where not unduly influenced by stock market considerations, business men took them and valued them conservatively, so as not to over-state their profits or worth. The imposition since 1917 of extraordinarily heavy taxes on income has led taxing officials to lay down rules for taking inventories designed to result in full disclosure of income, and the desire to get the benefit of using as invested capital the full allowable earned surplus has prompted business men themselves to revise understatements of inventories for previous years, made on the basis of their original conservative practices. The great slump in commodity values, now continuing, shows, however, how income, computed and taxed on a maximum basis, may prove to have been illusory. It is a fitting time to sum up the rulings which have been made about the use of inventories and to consider how those rulings should be modified to promote fairness in the levying of tax burdens and stability in business practices.

## FUNCTION OF INVENTORIES: ITS RECOGNITION IN THE TAX LAW

As income from a business consists broadly of the excess of assets at the end of the year over assets at the beginning of the year, it cannot be computed without bringing into account the goods on hand at the beginning and at the end of the year. The first provision as to inventories appearing in the law, however, is Section 203 of the 1918 law, reading as follows:

> That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any

taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

In the earliest act passed by authority of the Sixteenth Amendment (Act of October 3, 1913) and also under the second act (Act of September 8, 1916) net income was treated as consisting essentially of the excess of cash receipts over expenditures and no mention was made of inventories. The first provision of the law contemplating any other basis of income determination was that of Section 13 (d) of the Act of September 8, 1916, which recognized that corporations might render their returns upon the basis of accounts kept upon a basis "other than that of actual receipts and disbursements," provided that in the opinion of the Commissioner, such other basis clearly reflected its income.

From the outset, however, it was recognized under the regulations that at least in the case of certain corporations, inventories were necessary. (In principle, there is, of course, no basis for distinguishing between the accounting of a corporation engaged in business and that of an individual or partnership engaged in business.) Accordingly Regulations 33, issued January 5, 1914, provided for the use of inventories "by certain classes of corporations," although it did not specify the basis for pricing such inventories.[1] Under Regulations 33 (Revised), issued in January, 1918, after the vital changes effected by the Act of October 3, 1917, the treatment of inventories remained crude, no provisions being made as to most points of importance.[2] So far as forms were concerned, it was not until the appearance of Form 1031, issued in October, 1916, for the return of income by corporations, that any instructions as to the pricing basis were given. The basis set forth in small type on the back of that form was cost.[3] It was

[1] Art. 161.

[2] Par. 353, 354, 396, 481.

[3] "All manufacturing, mercantile or other corporations which determine their annual gain or loss by inventory are required to state the same in the form indicated below. If the annual income or loss is determined otherwise the methods employed must be stated in the space provided therefor. In case the annual gain or loss is determined by inventory, merchandise must be inventoried at the cost price, as any loss in saleable value will ultimately be reflected in the sales during the year when the goods are disposed of."

with the promulgation on December 19, 1917, of Treasury Decision 2609, authorizing inventories to be taken at "cost or market whichever is lower", that the subject first began to assume under the regulations the importance which it deserves. There is now in the Bureau a special and active section on inventories, and it is recognized by the Treasury that there is hardly any subject of greater practical importance, and probably none as to which so much divergence has existed in actual practice.

*Schedule A and Schedule A-2*: Schedule A of Form 1120 (the corporation income and excess profits return), on which the entire income computation is briefly set forth, calls, in line 2, for a deduction from the amount of gross sales of *the cost of goods sold* brought forward from Schedule A-2. It is on Schedule A-2, which has to be separately made out, that the use is actually made of the inventory figures. The taxpayer is there required to put down the inventory at the beginning of the period; to add to it purchases during the period, labor and wages ordinarily charged to manufacturing cost and other expenses ordinarily charged to such cost, and from the total so arrived at to deduct the inventories at the close of the period. The result so arrived at is to be taken as the cost of goods sold. It results accordingly that the larger the amount of the inventory, the smaller is the cost of the goods sold, and the larger the income.

It is not required, under the regulations or instructions given on the form, that the schedule be made up according to the exact method primarily indicated, but no method of getting at "cost of goods sold" which does not take inventories into account would be approved. The inventory used at the beginning of the year must be the same as the closing inventory for the previous year.

The use of inventories as required by Schedule A-2 priced on a basis which, in the case of goods manufactured by the taxpayer, is to include a proper allotment of overhead costs and perhaps also repairs and other items which are separately deducted on Schedule A in computing net income, has the effect of restoring in part deductions made under Schedule A.

The restoration of expense so made may be very important, as in the case of unit depletion deductions in the case of mines. This restoration of expressly authorized deductions might seem not to be required by law, but under the present law income determination is not so much a matter of literal application of specific provisions as a matter of proper accounting. Under the general method of accrual accounting usually applied to industries of any size, such a restoration of expense through inventory is proper and necessary. Its effect is simply to make a particular item of expense follow the goods to which it applies, and be taken as a deduction only when such goods are sold.

## Who Are To Use Inventories

*Taxpayers Engaged in a Trade or Business:* Inventories are prescribed in the case of those trades or businesses "in which the production, purchase or sale of merchandise is an income producing factor."[4] The merchandise must be such as to be capable of being inventoried; the use of inventories for "those engaged in the culture of oysters" is thus excluded.[5] In the case of farmers, the use of inventories is, however, still optional.[6] In all other cases in which inventories may be used, their use is apparently non-compulsory.

*Dealers in Securities.* Where, at an established place of business, securities are handled as merchandise that is, for purchase from and sale to customers with a view to the profit so derived, the use of inventories of the securities is permitted, provided the dealer "in his books of account regularly inventories unsold securities on hand, either (*a*) at cost, or (*b*) at cost or market value, whichever is lower" and consistently adheres to the method indicated. If securities are handled as merchandise in a branch of the business only, it is only the securities handled in that branch which may be inventoried.[7]

[4] Art. 1581; A. R. R. 217, 32–20–1115. Where not otherwise specified references to articles are to those included in Regulations 45.

[5] *Bulletin*, 35–20–1168.

[6] Art. 38.

[7] Art. 1585.

*Investors Not to Use Inventories.* It has been urged that the use of the inventory method should be permitted to any individual investor and should not be restricted to dealers, but the Treasury has hitherto refused to permit this, even in the case of extensive investors. Section 203 contemplates primarily the use of inventories "in trade or business," but it would seem that under the general power to approve methods of accounting which clearly reflects actual income the Commissioner might permit the use of inventories to individual investors if he should deem this advisable. The serious difficulty in determining and checking up market prices of securities not dealt in upon any exchange might be met by refusing to permit any market price to be used unless that price could be very clearly established. Unless permission was given to inventory securities at market when above cost, as well as when below, the extension of the use of the inventory method to private investors would not operate to relieve from the hardship of being obliged to take all the gain on securities as a profit in the year when realized by sale, but it would make it possible to take as a deduction a shrinkage in the value of unsold securities. It would operate to prevent the applying against income of a single year through the whole of a shrinkage in the value of securities occurring through several years.

### When Inventories Must Be Taken

The law prescribes as a fundamental requirement that income is to be computed "upon the basis of the taxpayer's annual accounting period." [9] Accordingly, there is required an inventory as of the first day and as of the last day of each taxable year. No question is likely to be raised as to the practice sometimes prevailing of using an inventory taken not on the last day of the year, but for convenience on the nearest Saturday or Sunday. The Treasury has ruled that a taxpayer who for many years has elected to take inventory only every two years and has used an estimated inventory in the return for the intermediate year, may not, when an actual inventory was

[8] A. R. R. 249, 35–20–1168.

[9] T. B. R. 48, 16–19–457; Cum. Bul. 1919 p. 47; Sec. 212(a).

taken, apportion his total earnings for the two years equally between such years for income tax purposes.[10] It is not permissible to have one period for taking the inventory and closing the books applicable to one part of the business and a different period for another part.[11]

Many of the difficulties in the use of inventories spring from the fact that the income of each year has thus to be set off sharply and completely from that of each succeeding and following year. With varying rates of tax and varying profits, the question of the year to which particular profits are to be allocated is often of great consequence. Inventory difficulties would be lessened by using as a basis for tax computation the average income for a period of years, as in the case of the British income tax on trading profits. Even though the report of the Royal Commission on the Income Tax, submitted in March, 1920, recommends that the British basis be changed to that of the profits of the single preceding year, on the ground that under the present system the adjustment of the tax lags too far behind changes in income, there should be careful consideration of placing in our law provision for the average basis. Clearly the provisions permitting a net loss in one year to be applied against the income of other years should be extended so as to cover all years.

## How Inventories Must Be Taken

> Inventories should be recorded in a legible manner and properly computed and summarized, and should be preserved as part of the accounting records of the taxpayer.[12]

On the actual return all that need appear is a summary of the inventory. There must also be filed with the return a "Certificate of Inventory" (Form 1126), setting forth under oath the basis upon which the inventory was taken, the names of those under whose direction the various parts were taken, and the affidavit of such persons that each such part was truly and completely taken.

[10] O. D. 133, 4-19-211, Cum. Bul., 1919, p. 63.
[11] O. D. 289, 23-19-541, Cum. Bul., 1919, p. 62.
[12] Art. 1582.

In the original regulations, it was stated that "a physical inventory is at all times preferred, but where a physical inventory is impossible and an equivalent inventory is equally accurate, the latter will be acceptable. An equivalent inventory is an inventory of materials, supplies and merchandise on hand taken from the books of the corporation." [13] Since the publication of these original regulations, there has been nothing set forth in official publications as to the method of the quantity determination. The taxpayer must always be able to show, however, that the inventory is accurate, and in the light of experience it is difficult to demonstrate accuracy except in the case of a "physical inventory;" that is, an actual first-hand count of the goods. It is important for the taxpayer to be able to show that the count was made by such persons and in such a way as to be reliable. The use of the tag system helps the proof of accuracy. It is not required that the count be made all on any one day, as this is often impossible. In some lines, as, for example, chain stores, inventories are successively taken in different stores by a trained inventory crew, and running book inventories for all stores checked in the light of frequent physical inventories, are reported as of the closing date. Inventories so made up may be among the most accurate. In some manufacturing lines—as in certain shoe factories—it is the practice at the end of the "season's run" to close successively each room of the factory, sending forward for the next process all possible unfinished stock, so that in the end the inventory reported consists almost entirely of raw materials and finished goods. Such an inventory, while most satisfactory, is not strictly as of the closing date; the new material put into manufacture after the inventory process is begun being under this system treated as a cash advance in respect of the next season.

## What Is to be Included in the Inventory

Except in the case of dealers in securities, business inventories relate to physical objects. Incorporeal assets, such as

[13] Reg. 33, Art. 161.

accounts, bills or notes receivable, stock or bonds are listed at cost and are in practice never referred to as part of the inventory.[14]

In the field of physical property, the fundamental distinction is, of course, between those items which continue serviceable for an extended period and are classed as *plant or equipment* and those which are the subject of constant purchase and sale, such as raw materials and finished goods, or those which have constantly to be replaced, like supplies. A certain limited class of items may be of such a character as to be capable of being classed either as part of the inventory or as part of plant and equipment, according to the situation and usages of the particular trade.

*Character of Items.* To be included are "raw materials and supplies on hand that have been acquired for sale, consumption or use in a productive process, together with all finished or partly finished goods." [15] In the case of some manufacturing enterprises, stock in process was wholly or partially omitted from the inventory or put in at a figure much less than cost or market, on the theory that a certain quantity must always be on hand and is never sold. Nothing in the regulations sanctions such treatment. If the taxpayer carries materials or supplies on hand for which no record of consumption is kept or of which inventories at the beginning and end of the year are not taken, it is permissible for him to include in his expenses the cost of such supplies and materials as are purchased during the year. [16] If, however, the amount of such materials and supplies is large, the Commissioner will presumably require that they be handled on an inventory basis.

*Scrap.* The requirement that everything on hand be included does not mean that goods have to be listed in a class to which they may have originally belonged, but to which they no longer belong. Damaged material, trimmings, cuttings and the like which have lost their original "new

[14] O. D. 541, 24–20–994, June Cum. Bul., p. 50.

[15] Art. 1581; also Art. 1584, as amended by T. D. 3109.

[16] Art. 102, p. 45; Reg. 33 (Rev.), Art. 13.

material" form may be taken at salvage value only unless by comparatively small expenditure they may be reworked so as to be suitable for manufacturing purposes. The Treasury, however, now gives very restricted scope to the class of scrap, and does not permit finished or partly finished goods which have become practically unsaleable to be treated as scrap.

Regulations 33 (Revised) contains a provision permitting the making of proper deductions for goods which "by reason of obsolesence or damage are unsaleable.[17] No such provision appears in the present regulations and the Treasury takes the view, although no ruling on the point has been published, that the former provision is overruled by Article 162 of Regulations 45, which states that depreciation, including obsolescence, "does not apply to inventories or stock in trade." Regulations 45 does revoke all prior regulations which are inconsistent therewith, but it seems clear that Article 160 of Regulations 33 (Revised) is not inconsistent with anything in Article 162 of Regulations 45, or elsewhere in the regulations, and that the Treasury's present attitude on this point should be modified so as to give recognition to the "best accounting practices" in various trades and industries."

"Depreciation," including obsolescence, is an allowance for a reserve to take care of losses reasonably expected to result from wear and tear and from damages in the arts. It applies only to plant items, not at all to stock in trade, and that is all that Article 162 says upon the point here involved. In the case of goods which have become damaged, unsaleable, or clearly saleable only in a lower class, or on the bargain counter, we are concerned not with a reserve for a future loss, but with mere recognition of what has already occurred. No business man would for a moment be excused by his creditors or stockholders for placing such goods in his balance sheet at their original value, nor would established accounting practices sanction such conduct. Nothing in the law prescribes such a practice. The implication of the law seems contrary to the present ruling of the Treasury.

[17] Art. 160.

Every taxpayer should, however, take particular pains to establish and record the facts with reference to all merchandise treated by him as scrap, unsaleable, or as saleable only at great sacrifice. In view of the present attitude upon the point he should expressly note on his return the deductions so claimed.

Illustrating the contention of the Treasury upon the point above discussed, is the ruling that liquor dealers were not allowed to leave off their inventories of December 31, 1919, liquors on hand, with the understanding that if disposed of for value the total receipts would be turned in as income.[18] The Committee took the view that the permission of the use of distilled liquors and wines for medicinal purposes gave some value to the goods on hand and that the goods should be inventoried on the basis of such value, if less than cost, even though the entire stock could not have been disposed of at any one time at such prices.

*Position of Items.* It is the theory of the Treasury that the taxpayer must include in his inventory all goods to which he has title, and must exclude any to which he has no actual title, regardless of the taxpayer's relation to the goods other than the relation of legal ownership. Thus, goods "sold" but not shipped are to be included (although they cannot be taken at less than cost). Consigned goods are to be included in the inventory of the owner. It is stated that consigned goods are not to be included in the inventory if they have been reported as sold, but it is difficult to see how consigned goods could in any case be properly treated as sold. Goods to which the taxpayer has received title but which have not yet been delivered at his warehouse are to be included, and special caution is made to include all invoices for goods in transit.

[18] A. R. M. 38, 13–20–804, Cum. Bul. No. 2, p. 54. Some practical relief on this point, as above described, has now been afforded by T. D. 3109 issued since this lecture was delivered (Dec. 13, 1920), modifying Art. 1584 as amended by T. D. 3047. As so amended this article now provides that where, owing to abnormal conditions, the taxpayer has regularly sold merchandise at prices less than replacement cost, he may, if taking inventory on the "cost or market, whichever is lower" basis, value the goods at such lower prices, subject to check in the light of his actual future prices. This provision affords relief in the case of goods which have lost in market value, but in terms confines relief to taxpayers fortunate enough "regularly to sell" their nearly unmarketable merchandise.

In view of the stress laid on title, it would seem that goods shipped sight draft against bill of lading might not be included in the inventory of the purchaser.[19]

A striking case of the application of the test of title was presented by mining companies which made a practice of delivering copper bullion to a smelting and refining company, where the bullion was mixed with other bullion and concentrates of different metallic content, under a contract by which the smelting and refining company was to return the equivalent of the metallic content of the ore, less commissions and other allowable charges. It was held that in view of the fact that the company so delivering the bullion was not to receive back metal made from the bullion so delivered, the transaction constituted a sale and not a bailment, and that the mining company should not include in its own inventory any bullion so delivered prior to the close of the taxable year, but in respect of such transactions, should include only so much of the metals as has been delivered by the refining company against the obligations arising through receipt of the bullion.[20]

*"Short" Items.* It was held by the Solicitor that where a taxpayer has borrowed stock in order to make a "short" sale, the gain or loss arising cannot be carried on his books (even though he be a dealer in securities) at the close of his taxable year by treating as an offsetting obligation the market value of the stock sold "short" as of that day.[21] As to contract commitments, it has been ruled by the Attorney General, sustaining the Treasury, that a taxpayer cannot treat, as if a part of his inventory, goods which he had contracted to purchase but which had not been delivered before the close of the year. The ground of the opinions, is that to permit the taking into accounts mere contract requirements would be contrary to sound accounting practices and would place the income statement on a speculative basis. The case of miscellaneous merchandise differs from that of stocks in that stocks have usually a more clearly defined market value and in that

[19] Art. 1581.
[20] S. 1373, 20–20–930, Cum. Bul. No. 2, p. 45.
[21] S. 1179, 24–19–558, Cum. Bul., 1919, p. 60.

the borrower may be called upon at any time for their return. A late ruling of the Committee of Appeals and Review applies the principle of the Attorney General's ruling to the case of cotton and grain merchants purchasing or selling "futures" against their commitments and holds that the "futures" can not be included in the inventory.[22]

## Valuation Bases: Cost or Market

*"Cost or Market, Whichever is Lower."* This general rule first promulgated by Treasury Decision 2609 on December 19, 1917, affirmed by T. D. 2744 based upon an opinion of the Attorney General, is set forth in Article 1582 as the fundamental basis. This is the rule recognized in Great Britain. Before December 19, 1917, the single basis here recognized is supposed to have been cost, although that basis was set forth only upon the corporation form appearing in October, 1916, (Form 1031) and never in a Treasury decision or ruling. The basis set forth in Treasury Decision 2609 represents a general conclusion as to the correct method of computing income, and it is clear that the Treasury will not revise returns of income for 1917 or prior years made upon the inventory basis recognized as correct in 1917.

The theory of taking the inventory at cost is, of course, that this results in deducting from the gross proceeds of goods actually sold during the taxable period, the exact cost of such goods. It is necessary, in order to accomplish this result, that cost of goods for the year must (1) include the cost of goods carried over from the previous period, and (2) exclude the cost of goods carried over to the succeeding taxable period.[23] Inventories taken at cost seem to accomplish precisely this result. Yet if, owing to changes in market conditions, the goods to be carried over are not worth the cost, it is clearly unjust to require the taxpayer to inventory the goods at cost. It was in order to avoid overstating income through taking the

[22] T. D. 3044; 30-20-1087; T. B. R. 15, 5-19-251, Cum. Bul. 1919, p. 154; A. R. M. 100, 49-20-331.

[23] T. B. R. 48, 16-19-1, Cum. Bul., 1919, p. 47.

inventory at an unduly high figure that business men worked out the basis of "cost or market, whichever is lower." As to the recognition of the use of this system in the administration of the tax, it was well pointed out by the Advisory Tax Board that while profits out of which a tax is to be taken, must be *proved*, and consist only of actual realizations, losses may be properly *admitted*.[24] The effect of admitting losses, even wrongly, is merely to postpone profits from one year to another, while the effect of failure to admit them is to treat as income that which is really capital.

Where "cost or market" is used, it applies to each item on the inventory and not to the inventory as a whole. The taxpayer does not compute the entire inventory at cost and also at market and choose the lower, but takes each item on the inventory and prices that particular item at cost or market, whichever is lower. Where a taxpayer is using this alternative basis he must show both cost and market for each item in the inventory. The most convenient way of taking the inventory is to use three columns opposite each item, in the first of which is recorded cost, in the second market, and in the third the lower of the two. The total of column 3 is the figure to be used in the inventory.

In the case of *commingled goods*, whatever basis of valuation is being used, goods which cannot be identified with specific invoices (or with a specific date of manufacture) are to be deemed the most recent goods.[25] Where the goods can be identified with specific purchases, the actual figures would govern.

### Valuation Bases: Cost

*Goods Purchased.* In the case of goods purchased, cost means primarily the invoice price.[26] From this is to be taken trade or other discounts, except strictly cash discounts approximating a fair interest rate. Such discounts may be deducted or not, at the option of the taxpayer, provided a consistent

[24] T. B. R. 48, 16–19–1, Cum. Bul., 1919, p. 47.

[25] Art. 1582.

[26] Art. 1583.

course is followed. It was held by the Treasury that taxpayers who, as a mattter of settled practice, do not deduct cash discounts from purchases, but who take the merchandise purchased into their inventories at invoice price (less trade or other discounts), carrying the discounts into a discount account, may not in valuing their closing inventories for income tax purposes, deduct from the invoice price of the merchandise the average amount of cash discount received on such merchandise or deduct from the discount earned an amount representing the estimated cash discount received on the merchandise on hand at the close of the year.[27]

To the invoice price is to be added transportation or other necessary charges incurred in acquiring possession of the goods. This would include not only railroad or steamship charges, but trucking charges, where it is possible to ascertain them. Such charge may also include customs duties and specific taxes, like sales taxes or excise taxes, as in the case of liquors or tobacco. A taxpayer is not permitted, however, to change at his election a practice once established with reference to the treatment of such items.[28]

The regulations do not require, however, that any part of the overhead for the year be assigned as part of the cost of goods purchased.

*Cost: Goods Manufactured or Processed.* In the case of goods manufactured, cost is to include:

*a.* "The cost of the raw materials and supplies entering into or consumed in connection with the product;"

*b.* "Expenditures for direct labor;" and

*c.* "Indirect expenses incident to and necessary for the production of the particular article including in such indirect expenses a reasonable proportion of management expense, but not including any cost of selling or return on capital, whether by way of interest or profit."

The proper course with reference to adding overhead expense to stock in process is not free from doubt. While logically such costs might well be added, practically it is often very difficult

[27] O. D. 326, 18–19–610, Cum. Bul., 1919, p. 56.

[28] Art. 132; Reg. 33 (Rev.), Art. 195; O. D. 137, 4–19–216.

to allocate them except on the basis of completed articles. However, Treasury Decision 3109, recently issued, insists that account be taken of burden in determining the cost of stock in process.

The specification of what is to be included seems to rule out any charge for interest or for rent or for "idle time" of machines, all of which are often reflected by cost systems.

*How Cost Is to be Determined.* While it is easy to say what items are to be included in cost, it is in practice very difficult to get at the amounts for each item which are to be allocated to various items in the inventory. It is accordingly recognized by the Treasury that what must very often be used is *estimated* cost. The statement in the regulations on this point is not particularly clear, but the Solicitor has ruled:

> It is recognized in some industries the actual cost of production cannot be ascertained accurately, and it is therefore necessary to approximate a cost value by using selling market prices as a starting point and reducing such selling market prices in each case by an amount sufficient to eliminate the element of profit. This rule is applicable to the inventories of farmers and stock men, and is widely used in many lines of industry, notably in those types of mining and manufacture in which a product of more than one grade is obtained by a common operation. Under its application a result can be reached that fairly approximates the inventory basis laid down in the regulations.[29]

Even when cost is built up, instead of reckoned back, averages and apportionments must frequently be used. It may fairly be said that in most cases, where manufacture is involved, "cost" is in fact the best practicable estimate, based upon actual figures wherever available. Special cost problems arise where the factory is not operated at full capacity. It would seem that in such cases the full overhead expense should not be apportioned.

The cost basis now carefully prescribed for *retail drygoods dealers* is a specific application of this estimating method. Under it the cost of the inventory is permitted to be computed by taking the *selling price* and deducting the amount of the average mark-up, careful allowance being made for all special mark-down sales.[30]

[29] O. 844, 6–19–268, Cum. Bul., 1919, p. 59; O. D. 25, 1–19–370, Cum. Bul. 1919, p. 75.
[30] Art. 1588, T. D. 3058, 35–20–1162.

*Cost Systems.* Cost systems are not in use in most cases. They are often difficult of application, and no ruling has been made prescribing their use. In cases in which the inventory is priced according to the results of the cost system, the tax payer must be in a position to show how the operation of the system ties in with the books of account, that is, how all actual expense is allocated, how the previous inventory is taken up, etc. Certain cost systems treat as an element of cost items like interest which are not required or permitted by the regulations to be so treated, and corrections would have to be made to exclude such items.

## Basis of Valuation: Market

*To What Items It Applies.* The regulations do not permit the market alternative to be applied to "goods on hand or in process of manufacture for delivery upon firm sales contracts at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost".[31] The idea underlying the permitted use of the market alternative is thus to permit only the reflecting of loss that seems certain. There is much practical difficulty in applying the "firm contract" limitation. It is often very difficult to tell what goods, except distinctively finished goods, apply against the contract. It is also very difficult, particularly in these times, to tell what is a firm contract. Certainly a contract which has been repudiated, or upon which the delivery of goods has been refused, should not be treated as firm. And if the price specified in the contract is itself less than cost, it should be permissible to value the goods applying to that contract at that price, instead of cost. Except for goods applying to firm contracts the alternative applies to all items in the inventory.

*"Market" Interpreted as Replacement Cost.* "Market" is described in the regulations as meaning "the current bid price prevailing at the time of the inventory." [32] It is not treated by the Treasury as meaning merely a price which in the judgment of the taxpayer is fair and reasonable. The regulations

[31] Art. 1584, Rev. T. D. 3047.
[32] Art. 1584.

do not specify whether the prices to be followed are those for the finished articles turned out by the factory, or those involved in the items entering into those articles, *i.e.*, prices in the selling market, or prices in the purchasing market. In connection with this, however, consult footnote 33, below. In practice, the Treasury appears to regard as "market" solely the cost of replacement of the goods by the taxpayer as to the date of the inventory. In the case of goods on hand in their original form, the actual replacement quotation can be used. In the case of goods wholly or partly manufactured, the market quotation or "current bid price" which is to be used is that for the raw materials in the goods on hand. If the constituent materials of the wholly or partially finished stock are at the date of the inventory quoted at less than their actual cost, there can be taken out of the inventory the difference between that actual cost and their replacement cost. The Treasury has not recognized, however, any right to take a deduction, in making this re-estimate, for a reduction in the cost of labor, or in the cost of manufacture due to the use of an improved process. Logically, however, such reductions should also be allowed where they can be clearly shown to apply to the replacement of any item in the inventory, and if the selling value of the finished goods, as determined on the market for such goods, is less than their cost, clearly this value should be permitted to be used. In such a case the selling value of the goods would be such as to prevent any profit whatever. No sound reason appears for limiting the scope of market to the replacement market, and ignoring the selling market.[33]

*Seconds.* In certain lines of manufacture there is normally a considerable production of goods which are defective, but nevertheless merchantable. Where it can be shown that these

[33] A very important Treasury Decision, 3109, issued after this lecture was delivered, amends Article 1584 and makes it now conform in part to the positions advocated in the above discussion: (1) It is now clear that in making the replacement cost estimate, *all* changes in elements of cost are to be considered, *i. e.*, *labor and burden* as well as cost of raw materials. (2) It is conceded that the price taken from the selling market may in some cases be used instead of that of the replacement market. This selling price is only to be used where, owing to abnormal conditions, the taxpayer has regularly sold goods at less than replacement cost and its use is subject to check in the light of the prices to which the taxpayer actually does sell after the date of the inventory. This decision also covers clearly for the first time the treatment of stock in process.

inferior goods—often called "seconds"—usually sell at some definite percentage less than the standard article, and the market alternative is used, it would seem to be proper to take this reduction in pricing the "seconds" included in the inventory. The "market" provision does not, however, justify the pricing of inferior goods at merely arbitrary or ultra-conservative figures.

*Proof of Market Price.* The ordinary method of proof is by "open market quotation," but the burden of proof rests upon the taxpayer in each case to satisfy the Commissioner of the correctness of the prices adopted. The taxpayer must, therefore, be in a position to show that market prices represent *bona fide* transactions in a free market in sufficient volume to furnish real evidence. Collusive or colorable sales would not be accepted as establishing market.[34] Where no open market quotations are available, the taxpayer is permitted to use "such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific private transactions in reasonable volume entered into in good faith, or compensation paid for the cancellation of contracts for purchased commitments." The evidence which may be so used may relate to a period after, although near, the close of the tax year. It is not settled how late the period may be, but the object always is to get at the market situation as it probably was on the closing date. Questions of difficulty arise where the market from which quotations must be taken are at a distance from the taxpayer's plant.

*Government Prices at the Close of 1918.* The regulations (Article 1584) provide as follows:

> It is recognized that in the latter part of 1918, by reason among other things of governmental control not having been relinquished, conditions were abnormal and in many commodities there was no such scale of trading as to establish a free market. In such a case where a market has been established during the succeeding year a claim may be filed for any loss sustained in accordance with the provisions of section 214 (a) (12).

A more just ruling applicable to the situation thus clearly recognized by the Treasury would be to permit the reporting

[34] Art. 1584, amended by T. D. 3109.

of inventories as of the close of 1918 on the basis of the prices established by the first free market in 1919, instead of merely permitting the filing of an inventory loss claim. The taxpayer should not be denied the benefit of valuing at market his closing inventory for 1918, even though by reason of the continuance of the nominal Government prices there were at the moment no actual market transactions. The Government prices in many cases meant nothing, because no goods were then bought or sold at such prices. The prices established on the first market subsequent to the removal of the restrictions do not indicate a reduction of the value of the inventory subsequent to the close of 1918, but rather indicate the actual facts as to the values which existed at the close of that year. The use of such prices in computing the closing inventory seems necessary in order to reflect the true income for 1918.

## Other Permitted Bases of Valuation

*Farmers and Growers of Live Stock: Market.* The Treasury recognizes the logic of the facts and rules that:

> Because of the impracticability of identifying livestock purchased and livestock raised, and the difficulty of ascertaining the actual cost of livestock and other farm products raised, farmers who render their return upon an accrual basis may, at their option, value their inventories for the taxable year according to the *farm price method*, which contemplates a valuation of inventories at market prices less cost of marketing.[35]

The basis here permitted for agricultural operations is not that of cost or market, but of plain *market*. Farmers first changing over to the "farm price" basis are required to treat as their opening inventory the inventory which was used for the close of the previous year, but they may revise their previous years' returns so as to place them upon the "farm price" basis if the income for the year of the change otherwise made is abnormally large.[36] This "farm price" inventory basis applies to all agricultural operations, like tobacco culture or the raising

[36] Art. 1585a, T. D. 3011, 18–20–18, Cum. Bul. No. 2, p. 57; A. R. R. 14, 2–20–688, *ibid.*, p. 56. *Cf.* Art. 1585a, amended, T. D. 3104.

[36] O. D. 481, 18–20–893, Cum. Bul. No. 2, p. 66.

of raw sugar, and will undoubtedly be accepted for the prior year as well as for the current year.

*Lumber Manufacturers.* A recent treasury decision provides that in the case of those who manufacture lumber from logs, in view of the impracticability of determining accurately the costs properly assignable to each grade and dimension of lumber making up the product of the mill, the taxpayer may use as a basis for price inventory, the *average cost* to the manufacturer of producing the various products during the whole of the taxable year; also that if the taxpayer regularly allocates in his books of account such average cost to the different kinds and grades of lumber in proportion to their selling value, a return upon this basis will be accepted.[37]

*Tobacco Companies: Average Cost.* It was finally ruled by the Bureau that "tobacco companies taking inventory on the monthly average cost method, no method more nearly approaching theoretical accuracy being practically possible, may continue such method in reporting for income tax." This is a partial reversal of the general ruling of the Advisory Tax Board excluding the average cost method.[38]

Under this method the materials purchased during the month, both as to quantity and cost, are added to the quantity and cost brought forward from the previous month and the average cost at the close of the month is computed by dividing the total quantity by the money figures, this average being applied to the quantity of materials used in the month and the net balance carried forward to the next month. This basis was disapproved by the Advisory Tax Board as not representing the actual costs for the taxable year, but was approved by the present Committee on Appeals and Review on account of its wide use in the industry and because under the peculiar conditions of the industry the application of ordinary methods for valuing the inventory did not appear to be practicable.

### Change In Inventory Basis

A taxpayer who has elected to take his inventories upon a particular authorized basis, which must be indicated in his

[37] Art. 1585b, T. D. 3024, 24–30–995, Cum. Bul. No. 2, p. 57.

[38] A. R. R. 18, 3–20–680, Cum. Bul. No. 2, p. 50; T. B. R. 48, *ibid.*, 1919, p. 47.

returns, cannot change from that basis without approval of the Commissioner. In the case of a shift from cost to "cost or market, whichever is lower," no such express provision was, however, required for returns filed for the year 1918, provided the newly adopted basis was indicated on the return. As to years subsequent to 1919 it was ruled that the taxpayer would not be permitted to change his basis of valuation where it appeared that the object of the change was to reduce tax liability. It is now ruled, however, that a taxpayer will be permitted for the present year to change from cost to "cost or market, whichever is lower," provided it is established that market at the close of 1918 and 1919 was higher than cost.[39] Any taxpayer desiring to make this change must, however, secure from the Commissioner written permission, based upon an application accompanied by satisfactory affidavits showing that at the periods indicated market was above cost.

Many taxpayers have been required by the regulations to shift from a basis by which inventories were valued low to one upon which higher valuations are used. Where such a shift is made at the end of any year the income for that year is unduly increased, unless there is a corresponding revaluation of the opening inventory, and as such a revaluation is accordingly in order. Such a change ordinarily involves recomputation of income for prior years, based upon proper adjustment of the inventories. Where the change in the inventory basis is not from an unauthorized to a proper basis, but from one authorized basis to another, as in the case of a shift from cost to "cost or market, whichever is lower" no ruling calls for or permits any change in the opening inventory or in the returns for prior years.[40] In the case of farmers changing from cost to the market basis an exception has been made permitting the use of an opening inventory on the market basis and adjustment of the returns from 1917 on upon the same basis.

[39] A. R. M. 85, 43–20–1273; Art. 23 (Rev.), T. D. 2873; A. R. M. 38, 13–20–804. A late treasury decision, 3108, amends Article 1582 to provide that a taxpayer may, regardless of his past practice, adopt the cost or market basis for 1920, provided a disclosure of the change is made upon the return. This does away with the necessity for securing the approval of the Commissioner in each case, and also for showing that cost was below the market at the end of 1918 and at the end of 1919.

[40] A. R. M. 38, 13-20-804.

## Bases of Valuation Not Permitted

*Market.* This basis is not permitted except (1) in the case of agricultural enterprises and (2), for constitutional reasons, in the case of *goods on hand March 1, 1913*. In general accounting practice its use is not sanctioned because it involves taking into account gains merely anticipated.

*Average Cost.*[41] Any average-cost basis involving the use of costs in prior years has not been approved, except in the case of tobacco growers and to a limited extent in the case of lumber manufacturers. The ground given by the Advisory Tax Board for the disapproval of this basis was that its use is not consistent with the requirement that the gains and losses of each taxable year be separately computed.[42] It was also suggested that if costs were to be averaged on a basis taking in prior years, then logically sales or receipts should be similarly averaged. In other industries besides tobacco, this method has undoubtedly been found the most practicable, and it is difficult to see how its use, approved in one industry, can be disapproved in any others in which it is similarly established.

*The Base-Stock Method.* The use of the "base-stock," "minimum" or "cushion" method of taking inventories was disapproved by the Advisory Tax Board in a carefully considered opinion.[43] According to this method a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on hand at all times. The grounds for the rejection of the use of this method were (*a*) that the practice was not in fact widely established; (*b*) that income computations on this basis were not accurate, in that it "ignores quasi capital gains for motives of prudence"; (*c*) that it was extremely difficult to determine a satisfactory base price and base quantity.

If the use of this method were established in the case of any business there would be much to say in justification of returns of income computed upon this basis. It is an almost

[41] Form 1126.
[42] T. B. M. 31, 16–19–1, Cum. Bul., 1919, p. 55.
[43] T. B. R. 65, 19–22–5, Cum. Bul. 1919, p. 51.

universal experience that supposed profits have consisted largely in mere replacement of inventory at higher prices, and have vanished when prices receded. The base-stock method of taking inventories prevents the reporting of such illusory profits. If a case arises in which this basis has been consistently used, it would seem advisable again to press the question before the Treasury. A difficulty of securing approval of the method is that of so formulating it that it may be made scientific and generally applicable.

### Inventory Reserves Not Permitted as Deductions

The regulations do not permit any deductions from inventory to offset possible future losses or to place the computation upon a conservative basis. This has been clear since December, 1917, if not since October, 1916, and the Treasury rigorously corrects returns of income computed upon the basis of such deductions from inventory. The wider knowledge of the disallowance of such reserves and the desire to recompute surplus so as to secure a full allowance of invested capital had led to many voluntary corrections by taxpayers of income returns for early years, based on computations involving flat cuts from the inventory.

It has been urged that where it has been the practice to make deductions so as to place the inventory at a safe figure, such deductions should be permitted to stand in the computation of taxable income. It cannot be denied that conservatism in the determination of business income benefits the public through promoting economic stability, or that taxing the full amount of income which may be offset by inventory losses is harsh, if not unjust. It is, however, impossible fairly to administer the tax law unless income is computed upon the basis of inventories taken according to established methods equally available to all. For the Treasury to pass satisfactorily upon the propriety of inventory reserves, to cover possible shrinkage, is difficult if not impossible. It cannot be claimed that any basis has yet been formulated by accountants for the systematic making and handling of such

reserves. In the present situation the Treasury can hardly do otherwise than decline to admit them as deductions from income. Constructive work by business men and accountants might lead to the establishment of scientific reserve methods for different industries, the open use of which would promote security and prevent imposition of tax upon merely paper profits. With such methods definitely worked out, their approval by the Treasury would be in line with the intent and provisions of the law. Until such methods are worked out, inventory reserves will undoubtedly continue to be treated as made from net profits rather than from gross income.

### Inventory Losses

The inventory loss provision of the Revenue Act of 1918, upon which taxpayers at first placed much reliance, has so far yielded very little relief. This is partly because the inventory shrinkage expected in 1919 did not develop, and partly because of the limitations placed on the scope of that section in the interpretation by the Treasury. The section provides in substance as follows:

Section 214 (a) 12.

*a.* At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year. . . . If it is shown to the satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the tax imposed by this title, the amount of such loss shall be deducted from the net income.

*b.* If no such claim is filed, but it is shown to the satisfaction of the Commissioner that during the year 1919 the taxpayer has sustained a substantial loss of the character above described, then the amount of such loss shall be deducted from the net income for the taxable year of 1918 and the tax imposed by this title for such year shall be redetermined accordingly. . . .

In the case of any claim for abatement the claim must be accompanied by a surety bond and if the claim is disallowed, interest on the amount of the tax unpaid by reason of the claim is assessed at one per cent. a month.[44]

[44] Art. 266.

Limitations which operate to deprive this provision of practical effect include the following:

1. The provision in its terms applies only to readjustments for the taxable year 1918, due to changes in inventory during 1919. The only possible justification for this time limitation was that extraordinary conditions might develop in 1919, which would not be expected to recur in later years. The expected after-the-war slump did not come until 1920. Every consideration which led to the placing of such a provision in the 1918 Act ought to lead to an amendment making the provision effective for the year 1919 and also available to take care of violent price fluctuations in later years.

2. The Treasury has treated "loss" as used in this provision as meaning a net loss upon the closing inventory for 1918 as a whole.[45] Under its rulings any gains realized in 1919 through the sale of part of the opening inventory are to be offset against shrinkages on other parts of the inventory. In order to determine whether or not there has been such a loss on the inventory as a whole, disposition of claims is postponed until after the close of the year 1919 and goods still on hand after the 1918 inventory are to be taken at their then market price if less than cost. In determining whether 1918 goods are then on hand, the presumption is applied that sales are satisfied, as they are made, from the goods longest on hand.[46]

A ruling more consistent with the apparent purpose of the section would be that loss is allowed in respect to any items in the inventory which show a shrinkage, regardless of profits on other items. What led to the adoption of the provision was the earnest insistence of business men that some plan be followed which would prevent the exaggeration of the profits of 1918 through the enforced taking of inventories at figures which in many instances would prove to be too high. The theory of the inventory loss section adopted in recognition of this just demand seems to be that the closing inventory for

[45] Art. 267, T. B. M. 52, Cum. Bul., 1919, p. 155; O. D. 186, 8-19-323, Cum. Bul., 1919, p. 154.

[46] Art. 263, 267.

1918 could be refigured in the light of the actual market developments of 1919. If at the close of 1918 the market value of particular goods in the inventory had already fallen off, those goods could have been inventoried on the basis of this lower price (if less than cost) notwithstanding the fact that other goods in the inventory showed a market price higher than cost. The inventory loss section should be given the effect of prolonging the period on the basis of which the inventory is to be computed, but not the effect of applying profits realized in 1919 on the disposition of articles against shrinkages on other articles. Such shrinkages are by law permitted to be taken as applying to 1918. Nothing requires the relating back to 1918 of gains made in 1919. The inventory loss section, like the "cost or market" provision, should be interpreted as applying to those items of the inventory on which, in the sense of the statute, there is a loss, and not to the inventory as a whole.

3. It was ruled by the Treasury that the loss to be allowed on goods sold is only to "the amount by which the value at which the goods sold were included in the inventory exceeds the actual selling price minus a reasonable allowance for selling expenses and for manufacturing expenses, if any, incurred in the taxable year 1918, and attributable to such goods." [47] It would seem, however, that the ruling should be that the loss to be allowed is the difference between the *replacement value* of the goods at the time of the sale, if less than cost, and the value at which they were taken in the inventory. The ruling in force appears to ignore the provision that the allowable loss must result from a "material reduction . . . of the value of the inventory" and does not make the allowable deduction in any way turn upon such a reduction.

Under the provision as interpreted by the Treasury, almost the only clear case where inventory losses were allowable is that of liquor dealers, whose stocks subsequently became unsaleable for beverage purposes on account of prohibition.[48]

The inventory loss provision is not easy to apply satisfactorily, but it is so just in principle that its scope should be

[47] Art. 264.

[48] O. D. 390, Cum. Bul. No. 2, p. 156.

extended to cover later years and the ambiguities as to its meaning should be removed.

## Goods Abroad—Foreign Money

The Committee on Appeals and Review has ruled that:

> Under the abnormal conditions characterizing foreign exchange during the European War, the taxpayer may convert current assets less current liabilities payable in the foreign currency at the current rate of exchange or at any rate less favorable to him. . . . This ruling should apply primarily to taxpayers trading or manufacturing in foreign countries and should not be held to apply to isolated or collateral investments in foreign credits or securities.[49]

Under this ruling the net profits of the operation of a foreign branch, except so far as actually remitted to the home office, are to be converted into United States money at the rate of exchange prevailing at the end of the taxable year, or at any rate less favorable to him. In the case of the amount actually remitted, the rate of exchange used in making the payment is to be employed.[50]

The Treasury has also ruled that foreign money on hand in a branch abroad at the close of the year, may be taken into account by treating it as converted into United States currency at the current rate of exchange.

## Future Developments

Because of the present slump in commodity values it is very clear that rigid rules laid down with much logical justification may work gross injustice through imposing tax on income which is not real. This injustice should lead to ameliorative provisions in the law itself, such as the extension to all years of the inventory loss sections and of the net loss sections. But it must also call for careful further consideration by the Treasury of its own rulings. Business men must be ready to assist the Treasury in its necessary task of placing the treatment of inventories upon an open and intelligible

[49] A. R. R. 15, 3–20–682, Cum. Bul. No. 2, p. 60; O. D. 489, 19–20–909, Cum. Bul. No. 2, p. 60.

[50] O. D. 550, 25–20–1009, Digest No. 11. *Cf.* pp. 50–52.

basis. The Treasury, however, must be ready to give much weight to the counsels of experience. It has under the law a mandate to give recognition to the "best accounting practice" in each trade or industry, and should not interpret this phrase as referring merely to methods which have been actually established, but as covering the best methods which can be established, in the light of experience, and with a view to meeting fairly the necessity of tax administration. Such consideration seems bound to result in the modification of some of the present requirements.[51]

[51] Just such a modification has recently been occurring. *Cf.* T. D. 3104, 3108 and 3109.

# CONSOLIDATED RETURNS

BY

WALTER A. STAUB, C. P. A.

*Origin and History.* Prior to 1917 none of our federal income tax laws permitted the filing of consolidated returns by affiliated corporations. Consequently, if one of two affiliated corporations showed a large profit, and the other a considerable loss, the full tax had to be paid on the profit without any offset being allowed for the loss sustained by the unprofitable company.

In many cases taxpayers, because of the small rate of tax imposed,[1] simply accepted the condition as it was, paid the tax in the case of the profitable company, and let it go at that. Others, however, of a more thrifty nature, in effect secured an offset for the loss by making inter-company charges or allowances, as, for example, management charges from one company to another, or a rebate on the charges previously made for merchandise supplied one company by the other.

The aim of such adjustments, where it was feasible to make them, was to reduce or practically eliminate the loss of the unprofitable company, and to reduce correspondingly the taxable income of the profitable company.

With the passage of the excess profits tax law, however, which imposed unprecedentedly heavy taxes and introduced an entirely new problem, *viz.*, that of determining invested capital as an essential feature of the administration of the tax, the Treasury recognized not only the justice of but also the necessity for consolidated returns in the case of corporations where there was either:

1. Affiliation or community of financial interest, as in the case of corporations where one or more companies were owned by a parent company, or where two or more corporations were

[1] From 1909 to 1915, inclusive, the rate was only one per cent., and for 1916 only two per cent., on taxable net income.

owned by the same interest or interests as individuals or partnership; or,

2. The business relations between the companies were such that even though there was not actual stock ownership in common, or by a parent company, it was possible to manipulate profits and losses as between the companies.

The 1917 law itself did not specifically provide for consolidated returns. Acting, however, upon the advice of the Advisory Tax Board, which the Commissioner of Internal Revenue had called into being, the regulations promulgated by the Treasury for the administration of the 1917 excess profits tax act provided for the submission of returns which, under certain conditions, were to be consolidated for excess profits tax purposes but not for purposes of the income tax.

The 1917 regulations permitting or requiring consolidated excess profits tax returns do not specifically state what section of the law is relied upon for such permission or requirement, but it is supposed to have been the following part of Section 201 of the Act of October 3, 1917:

> For the purpose of this title every corporation or partnership not exempt under the provisions of this section shall be deemed to be engaged in business, and all the trades and businesses in which it is engaged shall be treated as a single trade or business, and all its income from whatever source derived shall be deemed to be received from such trade or business.

It would seem from a reading of the foregoing section of the law that it was scarcely intended to provide for consolidated excess profits tax returns of separate corporations, any more than the general provision in the various income tax acts, requiring that all income from all sources be included in returns, could be construed as calling for consolidated income tax returns from affiliated corporations.

However, in view of the defects of the 1917 excess profits tax act and the possible harm which might otherwise have been done to business interests, the regulation was a very necessary one. Yet, as is pointed out elsewhere in this paper, some disadvantage was suffered by corporations joining in a consolidated return, in that they lost the benefit of another regulation

permitting the offsetting of liability against inadmissible assets. This last mentioned regulation also granted a privilege not provided in the law itself.

The regulation permitting consolidated returns met with widespread approval among business and financial interests and was thoroughly warranted from the standpoint of a fair administration of the law. The distinction between wholly-owned subsidiaries and a parent corporation, as well as between companies wholly owned by one interest or set of interests, is only a technical one and in fact is no more real, or for profits tax purposes justifiable, than it would be to require separate returns from the different departments of one corporation.

No case has, to the writer's knowledge, yet reached the courts in which taxpayers have insisted upon filing separate returns instead of a consolidated return for affiliated corporations, though it is a question whether, if there were an advantage in doing so, the taxpayer could not enforce the right to make separate returns. This is true, however, only with reference to the year 1917, as the law now in force [2] makes mandatory the filing of consolidated returns under which corporations are affiliated as defined in the act.

*What Corporations Should Make a Consolidated Return?* The 1918 law states that for the purpose of making consolidated returns, two or more domestic corporations shall be deemed to be affiliated:

1. If one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or

2. If substantially all the stock of two or more corporations is owned or controlled by the same interest.[3]

Article 633 of Regulations 45 states that "the words 'substantially all the stock' cannot be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case." The article goes on to state that:

> The owning or controlling of ninety-five per cent. or more of the outstanding voting capital stock (not including stock in the treasury)

[2] Section 240 of Act of February 24, 1919 (retroactive to January 1, 1918, and commonly referred to as the 1918 act or 1918 law).

[3] Section 240 (b).

at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required even though the stock ownership is less than ninety-five per cent.

When the stock ownership is less than ninety-five per cent., but in excess of fifty per cent., a full disclosure of affiliations should be made, showing all pertinent facts, including the stock owned in each subsidiary or affiliated corporation and the percentage of such stock owned to the total stock outstanding. Such statement should preferably be made in advance of filing the return, with a request for instructions as to whether a consolidated return should be made. In any event such a statement should be filed as a part of the return.

The words "the same interests" shall be deemed to mean the same individual or partnership or the same individuals or partnerships, but when the stock of two or more corporations is owned by two or more individuals or by two or more partnerships a consolidated return is not required unless the percentage of stock held by each individual or each partnership is substantially the same in each of the affiliated corporations.

In a case in which the construction of the phrase "substantially all the stock of two or more corporations" was at issue, the Treasury held as follows:

The application to make a consolidated return was denied in the case of two companies in one of which 24.26 per cent. of the stock of the first company was owned by individuals who held no stock whatever in the second company, and more than 6 per cent. of the stock of the second company was held by individuals who held no stock in the first company. Such a division of ownership cannot be considered either under the statute or the regulations as a case in which substantially all of the stock of two or more corporations is owned or controlled by the same interests.[4]

The regulations issued for the administration of the 1917 excess profits tax law, in defining affiliated corporations refer to two classes of affiliations, one due to stock ownership or control, and the other due to contractual or financial relations. The latter form of affiliation is stated to exist when one corporation:

(a) Buys from or sells to another products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or

(b) In any way so arranged its financial relationships with

[4] Income Tax Rulings 16–19–465.

another corporation as to assign to it a disproportionate share of net income or invested capital.[5]

The affiliation by reason of contractual relations is not mentioned in the 1918 act and no reference is made thereto in the regulations. It may, therefore, be assumed that from 1918 on, corporations which have a community of interests by reason of contractual or financial relations, but not by reason of common stock ownership or control, are not required to join in a consolidated return. As a matter of fact, it is difficult to see how corporations could establish such contractual or financial relations (other than stock ownership) as would, if they file separate returns, result in a lesser aggregate tax than if they filed a consolidated return.

For the purpose of determining whether or not corporations are affiliated within the intent of the present law, the Treasury has issued an elaborate "Affiliated Corporations Questionnaire" (Form 819) which must be filled out by all those corporations of whose outstanding voting capital stock more than fifty per cent. is owned or controlled by a parent company, or of which over fifty per cent. is owned or controlled by the same interests as have ownership of one or more other companies. The questionnaire calls for a mass of data. Many of the questions seem unnecessary for the determination of whether or not a consolidated return should be filed. Furthermore, the questionnaire would seem to be entirely unnecessary in those cases where the parent company, as is not unusual, owns one hundred per cent. of the stock of all its subsidiaries. It would be a decided accommodation to taxpayers if in such cases as that of the "Affiliated Corporations Questionnaire" the Treasury would confine itself to requiring such information as is really essential to the determination of the question up for consideration.

*Consolidated Returns Forbidden for Certain Classes of Corporations.* By restricting the definition of affiliated corporations to domestic corporations, the present law in effect forbids the inclusion of the invested capital and operations of a foreign corporation in a consolidated return. This is the

[5] Regulations 41, Art. 77.

case whether the foreign corporation is registered to do business in the United States or not. If it is, such foreign corporation must pay income tax to the United States on its income derived from sources within this country, and its stock owned by any American corporation, becomes an inadmissible asset to the latter. Dividends received from it are not subject to tax to the recipient. On the other hand, if it does not do any business whatever in the United States it pays no income tax to this country, its capital stock is an admissible asset to an American corporation, and its dividends are subject to tax (both income and excess profits) against the American corporation.[6] None of these conditions, however, change the fact that under the present law the invested capital and income of a foreign corporation cannot, under any circumstances, be merged in a consolidated return with an American corporation.[7]

The other class of corporations whose invested capital and taxable income are not permitted to be included in a consolidated return, is defined as follows:

> Any . . . corporation organized after August 1, 1914, and not successor to a then existing business, fifty per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[8]

[6] *Cf.* Regulations 45, Articles 301 and 834 and letter of Commissioner Roper to Corporation Trust Company, dated June 9, 1919.

[7] Section 240 (c) of the 1918 law, while excluding a foreign corporation from a consolidated return, permits the parent domestic corporation to deduct from the income and profits taxes payable by it "the same proportion of any income, war-profits and excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States, which the amount of any dividends (not deductible under Section 234) received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid: *Provided,* That in no such case shall the amount of the credit for such taxes exceed the amount of such dividends (not deductible under Section 234) received by such domestic corporation during the taxable year."

The regulations pertaining to the treatment of stock of foreign corporations in determining invested capital under the 1917 law prescribed a different procedure from that in force under the 1918 law. Article 46 of Regulations 41 reads as follows:

"In the case of domestic corporations or partnerships and of citizens or residents of the United States holding stock in a foreign corporation part of whose net income is subject to the income tax, there shall be included in invested capital such proportion of the value of the stock in such foreign corporation as the net income of such foreign corporation from sources outside the United States is of its entire net income."

[8] Section 240 (a).

The law further provides that the corporation so excluded from the consolidated return "shall be separately assessed on the basis of its own invested capital and net income."

*Should Partnerships and Owned Corporations be Consolidated?* This question need not be seriously raised under the law at present in force as the 1918 act is very explicit in limiting consolidated returns to affiliated *corporations.* The question has been raised, however, under the 1917 excess profits tax law. As has been stated in an earlier paragraph, the 1917 act contained no specific requirement for consolidated tax returns. If that paragraph of Section 201 of the act of October 3, 1917, which reads that ". . . every corporation or partnership . . . shall be deemed to be engaged in business, and all the trades and businesses in which it is engaged shall be treated as a single trade or business . . ." is the warrant for the Treasury regulations requiring consolidated returns in certain cases, it would appear just as permissible to require a partnership and corporations wholly owned by it, or substantially so, to make a consolidated return as in the case of affiliated corporations. Articles 77 and 78 of Regulations 41, however, in dealing with the subject of affiliated corporations and consolidated returns make mention only of corporations and give not the slightest intimation that a partnership and corporations owned or controlled by it would be required to make consolidated returns.

*Advantages and Disadvantages of Consolidating Returns.* The general impression has been that the permission to make consolidated instead of separate returns for a group of affiliated corporations must be of great benefit to the corporations. In some respects this is undoubtedly true. If the rate of earnings on invested capital of the various companies of a group varied materially, or if one or more companies sustained net losses while others of the group earned profits, the making of a consolidated return obviously is decidedly advantageous. As will be seen, however, from the later discussion of Inadmissible Assets and of Investments in Stocks of Subsidiaries, a consolidated return may as to these items result less advantageously to the group than if each affiliated corporation made a sep-

arate return. Also, by making a consolidated return all of the specific $3,000 and $2,000 exemptions which a number of corporations would get under separate returns are lost excepting the one $3,000 and one $2,000 allowed for the affiliated group as a whole.

It is practically certain that in a broad way corporations have benefited by being able to make consolidated returns in cases of affiliation. The fact that there are some disadvantages suffered as offsets to the benefits enjoyed—which in isolated cases may overbalance the benefits—is pointed out at this time merely so that the general thought may be in mind that there are various "give and take" elements involved in the consolidated returns provision.

*Determining Consolidated Taxable Income.* The determination of the consolidated taxable net income may involve the handling of a multitude of details and requires care in properly classifying the various items of gross income and deductions. It does not, however, involve many questions of principle other than those which may arise in preparing the return of a corporation which has no affiliations with any other company. While, in preparing a true consolidated income return, there are various eliminations to be made for inter-company transactions, these do not for the most part affect the final aggregate net income of the entire group of affiliated companies.

There is, however, one important principle to be applied in the determination of consolidated taxable income which finds no place in the return of a corporation having no affiliations. This is the elimination of inter-company profits forming a part of the value of goods in the inventory of one corporation which had been purchased from an affiliated company. The recognition by the Treasury of the propriety of eliminating inter-company profits from the inventories of affiliated corporations is but the application of an accounting principle that has been developed in the course of the past twenty years.

With the rise and growth of groups of corporations owned by a single parent corporation, it was seen that, regardless of the separate entity which each subsidiary corporation legally

possessed, the practical fact was that each subsidiary was to all intents and purposes but a department of one large business. Profits are not actually realized by the transfer or sale of goods from one department to another of the same business. Similarly, the apparent profit resulting from the sale of goods from one subsidiary to another or from a subsidiary to a parent corporation, or vice versa, is not actually realized until the goods are finally disposed of to the public. Unless inter-company profits are eliminated from the consolidated financial statements of affiliated corporations, it would be easily possible to inflate the profit showing by piling up inventories in those companies which conduct the more advanced steps of the manufacturing operations and having in such inventories considerable quantities of goods purchased from other companies of the group at a profit to the selling companies.

In determining taxable income, it is essential above all else that only definitely realized profits be included. Hence, the exclusion of inter-company profits which have not yet been realized because the goods on which they have accrued are still on hand, even though now owned by another company of the group, is essential to the correct and fair stating of consolidated taxable income.

It is rather strange, though it may be mere accident, that the Treasury regulations refer to the elimination of inter-company profits only in those articles which prescribe the method of determining invested capital for purposes of consolidated returns. No mention thereof appears in the articles referring to the determination of consolidated taxable net income. However, inasmuch as this is an instance of an item which, if applied in reduction of invested capital, is bound to have a corresponding effect on taxable income—inventory valuations must of necessity be consistently applied in the determination of both taxable income and invested capital—there can be no question but that the regulations intend that consolidated taxable net income shall be reported net of inter-company profits in inventories.

Further questions remain to be considered as to the procedure to be followed in cases:

*a.* When the affiliated companies had not been eliminating inter-company profits in preparing tax returns and it is desired to change to that basis;

*b.* When companies which were independent of each other became affiliated during the taxable year.

With reference to (*a*), it is to be noted that Regulations 45, which were promulgated for the administration of the 1918 law, contain the earliest reference by the Treasury to the subject of eliminating inter-company profits from inventories entering into a consolidated return. Article 864 reads in part as follows:

> The invested capital of affiliated corporations . . . for the taxable year is the invested capital of the entire group treated as one unit operated under a common control. As a first step in the computation a consolidated balance sheet should be prepared in accordance with standard accounting practices, which will reflect the actual assets and liabilities of the affiliated group. In preparing such a balance sheet all inter-company items, such as inter-company notes and accounts receivable and payable, should be eliminated from the assets and the liabilities, respectively, and *proper adjustments should be made in respect of inter-company profits or losses reflected in inventories which at the beginning or end of the taxable year contain merchandise exchanged between the corporations included in the affiliated group at prices above or below cost to the producing or original owner corporation.*

While the foregoing clause appearing in italics refers primarily to the stating and adjustment of the consolidated balance sheet for invested capital purposes, it is obvious that a corresponding adjustment is required in stating the consolidated taxable income. The same thought underlies the stating of the consolidated taxable income as the article just quoted applies to the determination of the consolidated invested capital, namely, that the true income of a group of affiliated corporations is obtained only when the entire group is "treated as one unit operated under a common control." Hence both the 1918 law and the regulation just quoted make mandatory, and not merely permissible, the elimination of inter-company profits included in the book profits of any affiliated corporations making a consolidated return.

The question remains as to how affiliated corporations which had not been eliminating inter-company profits in stating their

consolidated income shall make the change to the basis called for by Article 864. Prior to 1918 affiliated corporations were not permitted to make consolidated income tax returns. While consolidated excess profits tax returns were permitted for 1917, this was by administrative action rather than by direction of the law itself. Further, the income embraced in a consolidated excess profits return for 1917 was required by law to be the same as that reported in the separate income tax returns of the several affiliated corporations,[9] and the regulations promulgated for the administration of the 1917 excess profits tax law made no provision for any such modification of the aggregate of the income reported for the separate companies as the elimination of inter-company inventory profits.

It follows, that prior to 1918 there was no provision in either the law or the regulations for excluding or eliminating inter-company profits from the income or excess profits tax returns of affiliated corporations. It would, therefore, be logical to initiate the practice of eliminating such inter-company profits for the first time in preparing the consolidated return of a group of affiliated corporations for the year 1918. Should the change not be made until some time after 1918 it would appear that the proper procedure would be to file an amended consolidated return for 1918 and the subsequent years, giving effect to the elimination of inter-company profits as at the close of the period (fiscal or calendar year) for which the 1918 return is made and as at the beginning and end of each of the succeeding years for which amended returns are being filed.

It may be further pointed out that prior to 1917 the Treasury required that inventories should be valued at cost regardless of whether or not market values were less than such cost. In December, 1917, *i.e.*, after the enactment of the 1917 excess profits tax,[10] the Treasury issued a decision [11] recognizing the propriety of valuing inventories at either cost or market, whichever is the lower. This practice has continued to be

[9] 1917 law, Sec. 206 (c).

[10] Act of October 3, 1917.

[11] T. D. 2609.

recognized in principle since that time. Article 1582 of Regulations 45 provided *inter alia* that:

> A taxpayer may, regardless of his past practice, adopt the basis of cost or market, whichever is lower, for his 1918 inventory, provided a disclosure of the fact and that it represents a change is made in the return. Thereafter changes can be made only after permission is secured from the Commissioner.

Inasmuch as the elimination of inter-company profits from the inventories of a group of affiliated corporations is in effect reducing the inventories "of the entire group treated as one unit operated under a common control" to cost, Article 1582 would be an additional warrant for making the change in the 1918 consolidated return to the basis of valuing inventories exclusive of inter-company profits.

Regarding case (*b*),[12] nothing has come to the attention of the writer in either the formal regulations or the less formal rulings of the Treasury bearing on the question. Inasmuch as when corporations become affiliated during a taxable year they acquire a new relationship to each other, it would appear that the time for making the change to the basis of eliminating inter-company profits in inventories of the corporations now affiliated is the close of the period for which the initial consolidated return is made.

At first glance it might seem objectionable to eliminate such inter-company inventory profits at the close of the period without making corresponding adjustment at the beginning of the period. As against this objection, however, it is to be pointed out that the individual companies, prior to their consolidation, had already reported and paid taxes on such inter-company profits included in the inventories at the beginning of the period.[13] Since the change must be made some time, there is no more logical period than, or none in fact as logical as, the taxable year in which the affiliation among the corporations takes place.

Also, as will be seen from the later discussion of consolidated invested capital, affiiliated corporations sometimes suffer

[12] How or when inter-company profits are to be eliminated when companies which were independent of each other became affiliated during the taxable year. *Cf. supra*, p. 197.

[13] This follows the reasoning expressed in the Treasury's latest ruling concerning the determination of the taxable income of instalment businesses. T. D. 3082, October 20, 1920.

instead of benefit by the making of a consolidated return. Consequently, if they apparently benefit by eliminating inter-company inventory profits at the end of the period for which the initial consolidated return is made without making a corresponding elimination at the beginning of such period, one is in a sense a compensation for the other. This is but one instance of the "give and take" element which seems to be almost inevitable in the application of a general tax law to individual cases of infinite variety as regards the special circumstances in each particular case.

*Determining Consolidated Invested Capital.* In a broad way, the consolidated invested capital is but the aggregate of the invested capital resulting from the determination thereof for each one of the several affiliated corporations. The eliminations of inter-company items in preparing the invested capital schedule and the supporting schedules, such as the balance sheets at beginning and end of the period, are for the most part of a kind which do not affect the aggregate invested capital. There are, however, a number of most important exceptions, that is, cases in which by making a consolidated return, a different result will at times be reached for certain elements of the invested capital from what would be shown by merely aggregating the items as they would appear if a separate return were made for each of the several affiliated corporations.

Inter-company profits in inventories come into the class of exceptions referred to above. That subject has already been dealt with at considerable length in connection with the determination of consolidated taxable income and need not be considered again in connection with the consolidated invested capital as its bearing thereon is obvious. Other subjects which will need to be considered in some detail in connection with consolidated returns are those of inadmissible assets, intangible assets and especially the thorny question of the treatment of investments in subsidiary corporations in those cases where such stocks have been acquired for either more or less than the then book value thereof in the accounts of the subsidiaries.

*Inadmissible Assets.* The treatment of the inadmissible assets is perhaps the simplest of the several questions just mentioned. Obviously, if the point of departure for the determination of the consolidated invested capital is to be a consolidated balance sheet prepared on sound and accepted accounting principles,[14] the stocks of subsidiary corporations owned by the parent corporation will be entirely eliminated from the balance sheet, and only stocks of companies other than those forming part of the affiliated group would be taken into account in calculating the deduction to be made from the consolidated invested capital for inadmissible assets.

Were inadmissible assets required to be deducted, dollar for dollar, from the capital stock and surplus of corporations, the result would be just the same, whether the deduction for inadmissible assets were calculated separately for each company in the group and then aggregated, or whether the deduction were determined by making but one calculation for the inadmissible assets after having prepared the consolidated balance sheet. The 1918 law,[15] however, in effect requires that a corporation having liabilities deduct from its invested capital only such a proportion of the inadmissible assets as the invested capital before such deduction is of the gross assets. Or, expressed in another way, the deduction for inadmissible assets is the amount of such assets less a proportionate part of the corporation's liabilities. Therefore, it may make a great difference whether the deduction is calculated separately for each corporation and then aggregated, or whether the deduction is calculated *en bloc.* The difference will perhaps be more readily understood from the following illustration:

[14] For two excellent papers on the subject of consolidated accounts, the reader is referred to "The Accounting of Industrial Enterprises," by William M. Lybrand, C. P. A. (*Journal of Accountancy*, vol. 7, pp. 32–40, 111–121, 224–236) and "Consolidated Accounts" by George R. Webster, C. P. A. (*ibid.*, vol. 28, pp. 258–272).

[15] Section 326 (c).

SUMMARY OF BALANCE SHEETS OF TWO AFFILIATED CORPORATIONS HAVING THE RELATIONSHIP OF PARENT AND SUBSIDIARY CORPORATIONS

| *Assets* | *Corporation A* | *Corporation B* | *Consolidated* |
|---|---|---|---|
| Inadmissible assets: | | | |
| Stock of affiliated company | $1,000,000[16] | | |
| Other stocks and tax-exempt bonds | 500,000 | | $500,000 |
| | $1,500,000 | none | |
| Admissible assets; | 3,500,000 | $1,000,000 | 4,500,000 |
| Total assets | $5,000,000 | $1,000,000 | $5,000,000 |
| *Liabilities* | | | |
| Total indebtedness | $2,500,000 | none | $2,500,000 |
| Net assets | $2,500,000 | $1,000,000 | $2,500,000 |
| *Capital* | | | |
| Capital Stock | $2,000,000 | $1,000,000[16] | $2,000,000 |
| Surplus | 500,000 | none | 500,000 |
| Total capital | $2,500,000 | $1,000,000 | $2,500,000 |

Were the invested capital of corporations *A* and *B* to be determined separately, the calculation would be made as follows:

| | |
|---|---|
| *Corporation A:* | |
| Capital stock and surplus, as above | $2,500,000 |
| Deduct for inadmissibles: | |
| $\frac{1,500,000}{5,000,000}$ of foregoing $2,500,000 | 750,000 |
| Invested capital of *A* | $1,750,000 |
| *Corporation B:* | |
| Capital stock and surplus, as above (no deduction for inadmissibles necessary) | $1,000,000 |
| Aggregate of invested capital determined separately for each corporation | $2,750,000 |

[16] Offset and excluded in stating the consolidated balance sheet in the last column. For the sake of simplicity, it has been assumed that the stock of corporation *B* was acquired by corporation *A* at par and that corporation *B* has no undistributed surplus.

Determining the invested capital of the two corporations on the basis of the foregoing consolidated figures, the calculation would be as follows:

| | |
|---|---|
| Capital stock of parent company (all of subsidiary's stock owned by parent corporation,[17] and combined surplus of parent and subsidiary), assuming that none of subsidiary's surplus was accumulated prior to the acquisition of its stock by the parent corporation,[18] as above | $2,500,000 |
| Deduct for inadmissibles; | |
| $\frac{500,000}{5,000,000}$ of $2,500,000 | 250,000 |
| Consolidated invested capital | $2,250,000 |

It will be seen that the calculation of the invested capital on a consolidated basis is much less than if determined as the aggregate of the invested capital calculated for each company separately. In the illustration before us, the greater part of the difference of $500,000 between the respective amounts of invested capital determined on the two bases is due to the exclusion of the subsidiary corporation's capital stock from the calculation on a consolidated basis.

It is quite clear that (aside from the treatment of inadmissible assets representing securities other than those of affiliated corporations), if the parent company has any liabilities, the consolidated invested capital is bound to be less under either the 1918 act or the 1917 regulations [19] than the aggregate of the

[17] Article 864 of Regulations 45 provides that the consolidated invested capital shall include "the capital stock, if any, of subsidiary companies not owned by the parent or principal company, together with the surplus, if any, belonging to such minority interest."

[18] Article 864, above referred to, and articles 867 and 868 would, in effect, seem to exclude from consolidated invested capital any surplus of subsidiary companies, accumulated prior to acquisition of the subsidiaries' stocks, which is not represented in the price paid by the parent company in acquisition of such stocks. This subject is discussed on pages 209–216 under the heading, Investments in Stocks of Subsidiaries.

[19] While the 1917 excess profits tax law apparently required that the inadmissible assets be eliminated in full from invested capital, the Treasury permitted the corporation to offset its liabilities against its inadmissible assets and required it to reduce its invested capital by only the excess, if any, of inadmissible assets over liabilities (*cf.* Schedule C, Item 8, in Form 1003). This was presumably in pursuance of the theory that, had the corporation not acquired the inadmissible assets, it would not have had a corresponding amount of liabilities, and that therefore its invested capital would have been just as large did it not own the inadmissibles. The criticism might well be made, however, that the income from the inadmissible assets, whether dividends or stocks or interest on tax exempt bonds, was not subject to excess profits tax, whereas the interest paid on liabilities was an allowable deduction from income unless the indebtedness had been specifically incurred

invested capital determined separately for each of the affiliated corporations. This is the case because in determining the invested capital of each corporation separately the parent corporation would not deduct from its invested capital the full amount of the stocks of subsidiaries owned by it but only the portion required by the 1917 regulations or the 1918 act. In determining consolidated invested capital, however, the investment of the parent company in stocks of subsidiaries is in effect eliminated to the full extent to which such investment is represented by capital and surplus appearing on the books of the subsidiaries at the time of acquisition by the parent corporation.

The question may naturally be raised whether there is any justification for depriving the parent corporation (in the illustration it is corporation A) [20] of any part of the invested capital which would be shown if the two companies were to make separate returns. A corporation which owns a considerable part of the stock of another corporation, but not a sufficient amount ("substantially all") to bring it within the requirement for a consolidated return, pays no income or profits tax on the dividends received on such stock and yet indirectly is permitted (if the owning corporation has liabilities) to include a part of the investment in its invested capital. The parent corporation owning 100 per cent., or approximately so, of the stock of subsidiaries is in an analogous position but is deprived of any of the benefit—so far as its investment in subsidiaries is concerned—resulting from the favorable manner in which section 326 (c) permits the deduction for inadmissible assets to be made.

The only answer which presumably could be made is, that when a corporation has wholly, or almost wholly, acquired ownership of one or more others, they have to all intents become merely departments of one business and should

for the purchase of tax exempt securities. Probably in most cases the indebtedness in effect existing because of the ownership of inadmissible assets had been incurred indirectly and not in such a way as to make the interest thereon an unallowable deduction under Section 12 (a) of the Act of September 8, 1916, as amended October 3, 1917. The effect of the regulations under the 1917 law was to accentuate still further the difference under the 1918 law between the invested capital of affiliated corporations as determined separately and then aggregated and as calculated on a consolidated basis.

[20] In the final analysis the increased tax following any decrease in invested capital resulting from making returns on a consolidated basis falls on the stockholders of the parent corporation.

be treated as such rather than as separate units. There is now in reality but one investment, that of the parent company stockholders, the capital investment of the subsidiary being such in name only and all its stockholders (with the possible exception of an insignificant minority interest) having been replaced by the parent corporation's investment. On the other hand, as long as the companies are not sufficiently united in their financial relations to bring them within the requirement for a considerable return, there is presumably sufficient independent financial interest or investment in each corporation to warrant the making of separate returns.

Admittedly, this is not a very satisfactory answer. Evidently, if all the possibilities of the requirement for consolidated returns and of the provision prescribing the manner in which the deduction for inadmissibles is to be made were recognized before the enactment of the 1918 law—which, however, does not seem likely—the only conclusion possible would seem to be that it was felt that the line must be drawn somewhere with the effect already indicated.

Aside from the loss of invested capital suffered by excluding the investment in stocks of subsidiaries from consideration, there may be a further disadvantage sustained when determining the deduction for other inadmissibles in a consolidated return. For instance, if in the illustration shown on page 202 the stock of corporation *B* owned by corporation *A* were first eliminated, the comparison of the invested capital determined separately with that determined on a consolidated basis would be as follows:

| | |
|---|---|
| *Corporation A* | |
| Capital stock and surplus | \$2,500,000 |
| Less, Capital stock of company *B* | 1,000,000 |
| | \$1,500,000 |
| Deduct for inadmissibles; | |
| $\frac{500,000}{4,000,000}$ of \$1,500,000 | 187,500 |
| Invested capital of *A* | \$1,312,500 |
| *Corporation B* | |
| Capital stock and surplus (no deduction for inadmissibles necessary) | 1,000,000 |
| Aggregate of invested capital determined separately for each corporation | \$2,312,500 |

The invested capital determined on a consolidated basis, the calculation of which is shown on page 203, is $2,250,000, or $62,500 less than shown above. The latter amount represents the difference between:

1. One-eighth of Company *A's* liabilities of $2,500,000 which, under the separate calculation of *A's* invested capital, as shown above, is in effect allowed as invested capital in place of the $500,000 of inadmissibles other than *B's* stock owned, and

2. One-tenth of the liabilities of *A* and *B* (still aggregating $2,500,000 as *B* had no liabilities), which is in effect allowed as invested capital in place of the $500,000 of admissibles in the consolidated calculation.

The elimination of subsidiary stocks cannot under any circumstances result in benefiting the affiliated corporations when determining the invested capital on a consolidated basis. The calculation of the deduction for inadmissibles other than subsidiary stocks, however, will sometimes result more favorably for the taxpayer when the invested capital is calculated on a consolidated basis than when calculated separately for each affiliated company. This may be seen from the following illustration which is the same as that on page 202, excepting that the indebtedness is shown as being that of company *B* instead of *A*, and the former's admissible assets have been increased and the latter's decreased correspondingly. The capital stock and surplus of each company are the same in both illustrations.

| *Assets* | *Corporation A* | *Corporation B* | *Consolidated* |
|---|---|---|---|
| Inadmissible assets; | | | |
| Stock of affiliated company | $1,000,000 | | |
| Other inadmissibles | 500,000 | | $500,000 |
| | $1,500,000 | none | |
| Admissible assets; | 1,000,000 | $3,500,000 | $4,500,000 |
| Total assets | $2,500,000 | $3,500,000 | $5,000,000 |
| *Liabilities* | | | |
| Total indebtedness | none | 2,500,000 | 2,500,000 |
| Net assets | $2,500,000 | $1,000,000 | $2,500,000 |

| | | | |
|---|---|---|---|
| *Capital* | | | |
| Capital stock | $2,000,000 | $1,000,000 | $2,000,000 |
| Surplus | 500,000 | none | 500,000 |
| Total capital | $2,500,000 | $1,000,000 | $2,500,000 |

The invested capital if determined separately for each company would be as follows:

| | |
|---|---|
| *Corporation A* | |
| Capital stock and surplus | $2,500,000 |
| Deduction for inadmissibles (in this case, because of *A* having no liabilities, it would be the same whether the subsidiary stock is first eliminated or whether the deduction is calculated in accordance with section 326 (*c*) for the entire inadmissibles) $\frac{1,500,000}{2,500,000}$ of $2,500,000 | 1,500,000 |
| Invested capital of *A* | $1,000,000 |
| *Corporation B* | |
| Capital stock and surplus (no deduction for inadmissibles necessary) | 1,000,000 |
| Aggregate of invested capital determined separately for each corporation | $2,000,000 |

The invested capital calculated on the consolidated basis would be the same as in the first illustration (the consolidated assets and liabilities being the same in both illustrations) *viz.*, $2,250,000. This amount is $250,000 more than the aggregate of the invested capital determined separately for each corporation. This different result is due to the fact that in the second illustration *A* has no liabilities from which a benefit is to be derived in calculating the deduction for inadmissibles, whereas in making the calculation on a consolidated basis the advantage is had of the liabilities of *B* even though that company had no inadmissibles.

Whether or not a group of affiliated corporations will profit, or lose, as to its deduction for inadmissibles other than stocks of subsidiaries by making a consolidated return, will therefore depend on the circumstances in each particular case.

*Intangible Property.* In applying the limitation imposed by section 326 (a–4 and 5) on the amount of intangible property

which may be included in invested capital, Article 865 of Regulations 45 requires that, in the case of corporations whose affiliation is in the nature of parent and subsidiary companies, the limitation shall be applied on the basis of the capital stock of the parent corporation and the stock of the subsidiaries which may be held by others.[21] In the case of corporations affiliated by reason of ownership by the same interests, such interests, however, not being themselves a corporation, the article prescribes that the limitation is to be applied separately to each corporation.

The question suggests itself as to why this distinction is to be observed in applying the limitation on intangible property, whereas a similar distinction is not prescribed in making the deduction for inadmissible assets. The limitation on the inclusion of intangible property in invested capital and the requirement that a deduction be made for inadmissible assets both appear in the same section (326) of the 1918 law. Hence, it would seem only logical that, if a distinction is to be made between the two kinds of affiliation in applying the intangible property limitation, the same distinction should be observed in making the deduction for inadmissibles. In the Treasury regulations, however, Article 865, in dealing with the subject of intangibles, calls for the distinction referred to in the preceding paragraph, whereas, Article 866, in dealing with the subject of inadmissibles, requires the deduction to "be made on the basis of the consolidated balance sheet." Article 866 gives no intimation of any different procedure for the two different classes of affiliation.

Under the caption of Inadmissible Assets it was pointed out that the calculation on a consolidated basis of the deduction for inadmissibles may result in a smaller invested capital than if the deduction were calculated separately for each of the affiliated corporations and then aggregated. In the case of the

[21] The regulations relating to the procedure under the 1917 law read in part as follows: "Assets of affiliated or subsidiary corporations which have to be adjusted to meet the statutory limitations prescribed by section 207 shall be valued as of conditions existing at the dates when such assets were acquired by the respective affiliated or subsidiary corporations and not as of the date when the stock in such affiliated or subsidiary corporations was acquired by the parent or controlling corporation."

limitation on intangibles it would appear that—excepting in the rather infrequent event of the parent company stock being less than that of the subsidiaries—the application of the limitation *en bloc* cannot result in less, and may result in more, invested capital for the group than if the limitation were applied separately for each affiliated corporation. This is due to the fact that some of the companies may have no intangibles among their assets, or less than the maximum amount permitted to be included in invested capital. By applying the limitation *en bloc* the group obtains the benefit of the capital stock of these companies in the calculation, which would not be the case if the calculation were to be made separately for each company in the group.

*Investments in Stocks of Subsidiaries.* It has already been intimated that one of the really difficult questions which must be dealt with in determining consolidated investment capital arises when stock of a subsidiary has been acquired by the parent company for either more or less than the book value of the subsidiary stock at the time of acquisition. The Treasury regulations bearing on the subject are brief and read as follows:

> *Affiliated corporations; stock of subsidiary acquired for cash.* When all or substantially all of the stock of a subsidiary corporation was acquired for cash, the cash so paid shall be the basis to be used in determining the value of the property acquired.[22]
>
> *Affiliated corporations: stock of subsidiary acquired for stock.* Where stock of a subsidiary company was acquired with the stock of the parent company, the amount to be included in the consolidated invested capital in respect of the company acquired shall be computed in the same manner as if the net tangible assets and the intangible assets had been acquired instead of the stock. If in accordance with such acquisition a paid-in surplus is claimed, such claim shall be subject to the provisions of Article 837.[23]

It is relatively seldom that the stock of a subsidiary is acquired for exactly its book value at the time of acquisition. Taking up first those cases in which the parent company has paid a price greater than book value of the stock acquired, it would certainly seem that equity would require, that there is nothing in the law to forbid, and that the regulations above

[22] Art. 867.
[23] Art. 868.

quoted permit the inclusion in the consolidated invested capital of the entire amount actually invested by the parent company in the stock of the subsidiary.

The theory of the excess profits tax is that, when the earnings of a corporation are greater than a certain percentage of the capital invested in the business by its owners, a part of such excess earnings shall be paid over to the federal government. Now there is no question that when a parent company has paid an amount for the stock of a subsidiary in excess of the book value shown therefor at the time of acquisition there has been an actual investment of such excess payment. It may be true that the excess has not actually been paid into the treasury of the subsidiary, but has gone to the former stockholders of the subsidiary. Nevertheless, it is an actual investment by the parent company just as much as though the subsidiary had first been dissolved and its assets distributed and then bought by the parent company.

The parent company would presumably not pay more than the book value of the subsidiary stock unless the subsidiary had some assets, or an earning power which in turn creates an intangible asset, warranting the payment of more than the value at which its assets appear on the subsidiary's books. Therefore, inasmuch as the stock of the subsidiary carries with it ownership and control of such assets, the parent company is making an investment based upon the actual value of the assets of the subsidiary at the time of the acquisition of its stock. Also, while there is nothing in the 1918 law which would seem to forbid treating such excess payment for stock in a subsidiary as a part of the consolidated invested capital, it would seem entirely proper, and indeed be required by Section 326 (a-2), that in determining the invested capital of a parent corporation the full amount paid for the stock of a subsidiary should be included. There is no requirement or even intimation in the section mentioned that any deduction should be made from the parent company's or the consolidated invested capital because the amount paid for the stock of a subsidiary may exceed the book value of the stock.

In considering the other side of the question just under

discussion, that is, whether in the event of the stock of a subsidiary being acquired by the parent company for less than the book value of the former at the time of acquirement, the first inclination might be to say that naturally whatever rule has been laid down for one case should apply conversely when the reverse condition is found. This is evidently the position taken by the Treasury, as is seen from articles 867 and 868 which have been quoted on page 209. A strong argument is to be made for this view of the situation. The stockholders of the subsidiaries no longer have an investment therein; the capital of the parent company now represents the capital invested; the group of companies being treated as an economic unit, the effect of the acquisition of the stock of one or more subsidiaries was tantamount to the dissolution of such companies and the purchase of their properties and other assets at their then value.

In other words, a new deal has been made and, if the stock has been acquired for less than its book value, it is a bargain purchase and the transaction should be so treated in determining the consolidated invested capital. Further, any minority interest of the stockholders of subsidiaries is permitted to be included in the consolidated invested capital, presumably on the basis of the invested capital of such subsidiaries prior to their acquisition by the parent company. Article 864 of Regulations 45 reads in substance that

> In computing consolidated invested capital the starting point is furnished by the total of the amounts shown under (*a*) the capital stock of the parent or principal company in the hands of the public; (*b*) the consolidated surplus belonging to the stockholders of the parent or principal company; and (*c*) the capital stock, if any, of subsidiary companies not owned by the parent or principal company, together with the surplus, if any, belonging to such minority interest.

A strong argument, however, is also to be made for including in the consolidated invested capital the full invested capital which can be shown for a subsidiary on the basis of the original investment therein (together with subsequent accumulations) regardless of the fact that later the parent company may have acquired the stock for less than book value. While it is often said that it is a poor rule which does

not work both ways, and in a general way this may be said to be true, it can easily be demonstrated that there are exceptions. Those who used one of the earlier editions of Wentworth's Geometry may remember the illustration given to demonstrate that the converse of a proposition is not necessarily true. The illustration was that all horses are quadrupeds, but not all quadrupeds are horses.

It will also come to the mind of the experienced accountant that while he holds it to be a sound principle that when market values are less than cost, inventories shall be taken at market, he does not concede that, when market is higher than cost, market should still be used. It is recognized that while the principle of valuing inventories at cost or market, whichever is lower, may not be defensible from the standpoint of pure logic, there are nevertheless very good practical reasons why it should be adhered to and, as already pointed out, the Treasury has finally come to recognize that this is the case. Therefore, in approaching the question now before us, we should do it with a mind free to look at the merits of the case regardless of what our decision was when the conditions were just the reverse of those we are about to consider.

When a parent company acquires the stock of a subsidiary which is still continued as a separate legal entity, the parent company succeeds to the rights of the former individual stockholders and, if the invested capital as legitimately determined for the subsidiary company as a separate entity is not affected by the changing of its stockholders (if individuals), it would seem it ought not to be decreased for purposes of consolidation with the parent company merely because the latter may have acquired the stock of the subsidiary for less than its book value. If there was originally a *bona fide* investment by the former individual stockholders of the subsidiary which, at the time of acquisition by the parent company, still shows a legitimate invested capital in excess of cost of the latter, the relation of earnings to invested capital contemplated by the excess profits tax act would appear to be fairly on the basis of the present earnings compared with the *bona fide* capital invested and still remaining in the

business. When the individual stockholders sold their stock to the new parent corporation they took nothing from the invested capital of the subsidiary, and the parent company would seem entitled to make a bargain purchase just as any individual stockholder of the subsidiary might have made when he acquired his stock. It will doubtless be readily conceded that such bargain purchase by an individual stockholder could not have operated to reduce the admissible invested capital of the company whose stock he purchased.

In passing it might be pointed out, too, that in those cases where the parent company has paid more than the book value of the subsidiary the excess investment is in reality a part of the invested capital of the parent company, whereas in those cases where the parent company has paid less than the book value of the subsidiary stock the difference is in reality invested capital of the subsidiary, and in both cases the parent company and the subsidiary company, respectively, are entitled to contribute to the calculation of the consolidated invested capital the full amount of their invested capital utilized in the business "of the entire group treated as one unit operated under a common control." [24]

In cases where several corporations are wholly owned by a partnership, an individual or a syndicate, and thus are required under Section 240 to file consolidated returns, the invested capital allowed each of these affiliated corporations is not dependent (except in the case of original subscriptions for stock) on what amount was paid by the partnership, individual or syndicate for the stock of any one of these companies. Equity and consistency would, in the absence of any specific law requirement to the contrary, decree that like treatment should be accorded affiliated corporations which have this relationship because of their common ownership by a parent corporation instead of by a partnership, individual or syndicate.

It is conceded that if, instead of buying stock of the subsidiary, the parent company had purchased part or all of its assets, only the amount paid would be allowed as invested

[24] Art. 864.

capital regardless of the investment by the preceding owner. This, however, is not an argument for including in the consolidated invested capital the investment by the subsidiary at only the amount paid for its stock by the parent corporation. When specific property, other than capital stock, changes hands, the purchaser, even though he has made a bargain purchase, cannot value for invested capital purposes such assets purchased at more than their cost to the purchasing company. If the stock of a company changes hands, however, there has legally not been a transfer of the assets owned by the company but merely an evidence of changing interest in the company. It would seem to be the intent of the excess profits tax act that, so long as the corporate existence is maintained, its invested capital shall continue to be determined in the same manner regardless of changes among the holders of its capital stock. When, however, the corporation is dissolved or specified assets are otherwise alienated from the corporation, the new owner's investment in such assets must form the basis of invested capital if such new owner is subjected to excess profits tax.

The general intent of the permission granted by Section 240 of the 1918 act for consolidated returns by affiliated corporations was evidently to confer a boon and not to impose a penalty. This is evidenced by the provision prohibiting the inclusion in a consolidated return of the operations of a corporation organized after August 1, 1914, and deriving its principal income from war contracts. To require the elimination of a part of the actual invested capital of a subsidiary company merely because it exceeded the purchase price paid by the present owner of its stock would, however, be imposing a penalty on the consolidation. In place, however, of any intent to impose penalties on parent companies, the 1918 act on the contrary eliminated the discriminatory two per cent. income tax which holding or parent companies had by former laws been required to pay on dividends received by them from their subsidiaries.

Before leaving this subject, the question may be raised as to what the attitude of the Treasury would be in the event of a

subsidiary with a capital stock and book surplus of, say, $1,000,000, whose capital stock was purchased by a parent company for, say, $800,000, selling its plant or otherwise converting its assets so that they would indisputably be in cash or its equivalent amounting to $1,000,000. For the purposes of the illustration it is assumed that all the earnings of the subsidiary, subsequent to acquirement of its stock, have been paid over to the parent company.

The conversion of assets into cash or its equivalent would result in no profit to the subsidiary, as the realization does not exceed the book value of the assets. Neither has any taxable income been received by the parent company; if no part of the $1,000,000 has been paid over to the parent company there has been merely an appreciation in the value of the subsidiary's stock held by the parent company, and if $200,000 (excess of $1,000,000 cash or equivalent over cost of $800,000) had been paid to the parent company as a dividend, it would not be taxable to the parent company.

Under the Treasury regulations already quoted,[25] the consolidated invested capital would include only $800,000 for the subsidiary. Since this is the actual investment by the parent company there is some argument for using it, but when the assets of the subsidiary clearly amount to $1,000,000 in cash or its equivalent it seems absurd to say that the invested capital for the subsidiary is only $800,000. Just when the additional $200,000 should be added to the invested capital, admitting for sake of discussion that the Treasury regulation is reasonable under ordinary circumstances, offers the difficulty. The thought is offered for consideration that there is some analogy between a case such as that described and one in which appreciation accrued prior to March 1, 1913, is realized. Until realization, such appreciation cannot be included in invested capital. After realization, however, even though it is not taxable, the appreciation may be included in invested capital. Similarly, after the difference between the invested capital of the subsidiary as a separate entity and the price paid for its stock by the parent company has been

[25] Regulations 45, Arts. 867 and 868.

realized in cash or its equivalent, it would appear to be a proper item for inclusion in the consolidated invested capital.

*Pre-war Consolidated Invested Capital.* While pre-war invested capital and income have a bearing on but few of the returns now being made, the questions connected with their determination are still of importance because of the many consolidated returns for 1917 and 1918 which are yet to be audited by the Treasury. The Treasury regulations bearing on this question read as follows:

> The invested capital of affiliated corporations for the pre-war period shall be computed on the same basis as the invested capital for the taxable year, except that where any one or more of the corporations included in the consolidation for the taxable year were in existence during the pre-war period, but were not then affiliated as herein defined, then the average consolidated invested capital for the pre-war period shall be the average invested capital of the corporations which were affiliated in the pre-war period plus the aggregate of the average invested capital for each of the several corporations which were not affiliated during the pre-war period. Full recognition, however, must be given to the provisions of section 330 of the statute, particularly the last paragraph thereof, . . ."[26]

Section 330 of the statute deals with the determination of pre-war invested capital and pre-war income "in the case of the reorganization, consolidation, or change of ownership after January 1, 1911, of a trade or business now carried on by a corporation." The intent of the section is "to place the computation of the (pre-war) invested capital . . . on the basis employed in determining the invested capital for the taxable year.

The regulations quoted above refer to computing the pre-war invested capital of those companies which were affiliated in the pre-war period and also those corporations which were subsequently acquired and consolidating them to determine invested capital for pre-war period. No mention is made, however, of what should be done in computing pre-war invested capital or income if one company of the group went out of existence or was sold subsequent to the pre-war period. From an ideal standpoint it would be desirable to state the pre-war invested capital on the same basis as for the taxable period,

[26] Art. 869.

*i. e.*, eliminating from the pre-war figures those of the subsidiary which is no longer in the group.

The elimination of the pre-war income of the subsidiary would be a simple matter but not so as to the invested capital. What corresponding elements are to be eliminated from the parent company's balance sheet when eliminating the investment in the subsidiary? Is an amount corresponding to the investment in the subsidiary to be eliminated from the capital stock and surplus of the parent company? Or, is the elimination to be made from the liabilities of the parent company on the assumption that the proceeds of the sale or dissolution of the subsidiary have in effect been used to reduce the parent company's liabilities? Or, are the proceeds simply to be considered as increasing the current assets of the parent company? Each of these methods would have a different effect on the consolidated invested capital.

Any one of the above mentioned methods offers difficulties of application. From a practical standpoint, it would seem best not to attempt to eliminate the subsidiary in determining the pre-war invested capital of the group and to allow the adjustment to come through that section of the law which provides that in determining the war profits credit there shall be added or deducted from the average pre-war income "10 per centum of the difference (increase or decrease, respectively) between the average invested capital for the pre-war period and the invested capital for the taxable year.[27] In determining the average pre-war earnings for purposes of the 1917 excess profits exemption, it would seem fair to compare the pre-war earnings with invested capital of the companies then owned and of any since acquired.

*Losses in Pre-war Period.* Another question which apparently was not considered in the Treasury regulations is how losses in the pre-war period were to be applied in the case of consolidated returns.

In the 1918 Excess Profits Tax Primer there is a question and answer (number 15) which refers to pre-war losses in the

[27] 1918 law, section 311 (a-2).

case of a single company. If the company had profits in two years and a loss in the other year of the pre-war period, the Treasury held that the loss of one year need not be applied against the profits of the other years. In the illustration given in the Primer, the profits of the two years are added and the sum divided by three to determine the average annual profits of the pre-war period. It was stated that "the loss . . . is disregarded inasmuch as the income tax law does not permit the loss of one year to affect or reduce the profit of another year."

Now the question is whether the above mentioned illustration is to be used as a guide and the average pre-war income determined for a group of affiliated corporations in the same manner. If so, the taxable income reported by the various affiliated companies during the pre-war period would be aggregated and (without making any deduction for losses which some of the companies may have sustained during one or more of the pre-war years) the total divided by three to ascertain the average consolidated pre-war income.

If, following the Treasury's reasoning in the Primer, a group of affiliated corporations showed a net loss for one or two years of the pre-war period, such loss would not have to be deducted from the net profit of the group for the other years in calculating the average pre-war income. The law still makes no provision [28] for offsetting losses of one year against the profits of other years. Therefore, while losses of one company may now, in making a consolidated return, be applied against the profits of an affiliated company in the same year, the latest act still does not permit a net loss of the group for one year to be applied against the net profit of the group for another year.

Since, however, profits and losses may, since 1918 as to both income and profits taxes, and since 1917 as to excess profits tax, be offset in a consolidated return, must they be offset in the pre-war period? Let us assume that three affiliated companies showed the following results during the pre-war period:

[28] Excepting for one specific period. *Cf.* 1918 law, sections 204 (b), 214 (12) and 234 (14).

| *Company* | *1911* | | *1912* | | *1913* | | *Consolidated (Net Profit)* |
|---|---|---|---|---|---|---|---|
| *A* | Profit | $50,000 | Loss | $10,000 | Profit | $40,000 | $ 80,000 |
| *B* | Loss | 10,000 | Profit | 50,000 | Profit | 60,000 | 100,000 |
| *C* | Profit | 50,000 | Profit | 50,000 | Loss | 10,000 | 90,000 |
| Annual net profit | | $90,000 | | $90,000 | | $90,000 | $270,000 |
| Average pre-war income | | | | | | 1/3 | 90,000 |

If losses are to be applied against profits of the same years, the average pre-war income for the group would be, as above, $90,000.

Suppose, however, that the losses all occurred in one year and that the same total net profit had been earned in the pre-war years as follows:

| *Company* | | *1911 (Profits)* | | *1912 (Losses)* | | *1913 (Profits)* | *Consolidated (Net Profit)* |
|---|---|---|---|---|---|---|---|
| *A* | | $50,000 | | $10,000 | | $40,000 | $80,000 |
| *B* | | 50,000 | | 10,000 | | 60,000 | 100,000 |
| *C* | | 50,000 | | 10,000 | | 50,000 | 90,000 |
| Annual net result— | Profit | $150,000 | Loss | $30,000 | Profit | $150,000 | $270,000 |
| Average pre-war income | | | | 1/3 | | | 90,000 |

Following the Treasury's reasoning, the pre-war consolidated income would in the latter illustration, be not $90,000 but $100,000. The later figure is the sum of the profits for 1911 and 1913 divided by three.

Is there any more reason for holding the pre-war consolidated income to have been $100,000 in the one case than in the other?

This is but another illustration of the fact that mere accident often plays an important part in the determination of the amount of excess profits tax payable by a taxpayer.

*Stock Dividends.* Stock dividends of subsidiary corporations to the parent company would, of course, make no change in the consolidated invested capital, and similarly stock dividends of the parent company to its stockholders would not effect any change in the conslidated invested capital.

*Change in Ownership during Taxable Year.* The Treasury gives no instructions to be followed in such a case, merely

saying that in the case of new subsidiaries acquired, or companies becoming affiliated during the year through common ownership, or *vice versa*, full statement shall be made of the facts to the Commissioner and he may, in accordance with the peculiar circumstances in each case, require either separate or consolidated returns to be filed, to the end that tax may be equitably assessed.[29]

It would appear that either separate or consolidated returns should be filed, according to which seemed warranted by the circumstances of the case. In due course the return or returns will be reviewed by the Commissioner and final determination of the question then be had. Either the returns filed will be definitely accepted or the filing of amended returns will be required.

In one case of changing affiliations during the taxable year which came to the writer's attention, a consolidated return was made for the entire year, though the companies became affiliated only during the year, with substantial justice resulting to both the corporations and the Government. The facts in the case, very briefly stated, were that a mercantile company during the year increased its capital stock, got new money into the business, and purchased two other companies' manufacturing goods like those sold by the mercantile company. A consolidated return was made for the calendar year, the invested capital of the mercantile company being computed for the entire year. This in effect included the invested capital of only the parent company merely to the time the subsidiaries were acquired and the capital invested in the operations of all three companies after they became affiliated. There was then added thereto the invested capital of each of the subsidiaries (the two manufacturing companies), computed separately for the fractional part of the year which had elapsed before they were acquired by the parent company. This gave the consolidated invested capital, which served as the basis for determining the excess profits tax to be paid on the aggregate taxable income of the three companies for the entire year. This way of handling the situation seemed to result in substantial justice in this particular case.

[29] Art. 634.

*Different Fiscal Years of Corporations.* The following regulation deals with the question of the period for which a consolidated return is to be made:

In the case of all consolidated returns, consolidated invested capital must be computed as of the beginning of the taxable year of the parent or principal repoıting company and consolidated income must be computed on the basis of its taxable year. Whenever the fiscal year of one or more subsidiary or other affiliated corporations differs from the fiscal year of the parent or principal corporation, the Commissioner should be fully advised by the taxpayer in order that provision may be made for assessing the tax in respect of the period prior to the beginning of the fiscal year of the parent or principal company.[30]

*Exemptions.* In the case of the specific $3,000 war and excess profits credit and the $2,000 income exemption, respectively, the 1918 law definitely provides that only one exception of $3,000 for war and excess profits credit and one $2,000 income exemption shall be allowed to a group of affiliated companies making a consolidated return.

The act does not state whether the Liberty bond exemptions shall be allowed to each company separately or only one set of exemptions to the group as a whole. The Treasury, however, has held that:

Each of several affiliated corporations . . . is entitled to the same full benefits under the exemption provisions of the several Liberty bond acts to which it would be entitled if not affiliated.[31]

*Information Returns.* It is to be borne in mind that:

Corporations which are affiliated within the meaning of Section 240 of the Revenue Act of 1918 are required to make a consolidated return of net income and invested capital, but they will not be permitted to file a consolidated return of information at the source. Each corporation must file a separate return of information as required by Section 256." [32]

[30] Art. 638.

[31] Income Tax Rulings, 12–19–171.

[32] *Ibid.*, 16–20–868.

# THE TAXATION OF INCOME FROM NATURAL RESOURCES

BY

R. V. NORRIS, E.M., M.Sc.

The imposition by the United States Government of income and excess profits taxes, dating from the adoption of the Sixteenth Amendment to the Constitution, February 25, 1913, has forced much more careful analysis of values and of income than was previously necessary. This is particularly the case with the industries based on wasting natural resources, in which the raw material is either irreplaceable as in the case of mineral, oil and gas, or so slowly replaceable as timber, as to be classed with these.

The importance of this source of taxation is evidenced by the fact that the mineral and metal industries paid in 1916, 34.5 per cent. and in 1917, 35.1 per cent. of the total taxes paid by corporations (Graton, A.I.M.E., September, 1919).

The principles involved in the taxation of these wasting assets, while in general the same as for other taxation, differ in the necessity for a depletion allowance as distinguished from depreciation or amortization. The Revenue Act of 1918, Part I, Section 214 (a) (10), reads as follows:

> In the cases of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: PROVIDED, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: PROVIDED FURTHER, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of

the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

This language is repeated, Part II, A, Section 234 (a) (9), applying to corporations. It is under this section that the income from the wasting industries is differentiated from all other income, in that depletion deductions are allowed.

The rules and regulations referred to in the law "to be prescribed by the Commissioner" are embodied in Treasury Regulations 45, Articles 201 to 235 inclusive. These regulations have the force of law, in fact are a part of the law. However, they are amended from time to time and also modified in accordance with Court decisions, so that it is practically impossible to discuss this matter with assurance that the data presented are fully up to date, and most inadvisable to rely on even relatively recent publications for the present status of the law.[1] As a matter of fact it has been necessary to recast this entire paper to take into account the revised rulings, approved December 29, 1920.

*Capital.* The law and the regulations bring up sharply a distinction drawn between invested capital of the excess profits tax (Sec. 326) and value for depletion (Sec. 214). Invested capital (Art. 831) is defined as "the capital actually paid in to the corporation by the stockholders, including surplus and undivided profits, and is not based on the present net worth of the assets as shown by appraisal or in any other manner."

As applied to the wasting industries the definition of invested capital seems unfair; it is an undisputed fact that the values of operating mines, oil and gas wells, etc., bear but little relation to the actual cost. A developed and operating property may well have a market value far greater than the sum of the cost of the undeveloped property and of the capitalized cost of development.

[1] In the following references to Sections refer to the law and to Articles to Regulations 45. With respect to the legal force and effect of these regulations, *cf. supra*, p. 91 *et seq.*

This matter was carefully studied by the Committee on the Federal Taxation of Mines of the American Institute of Mining and Metallurgical Engineers, who in their report recommended that Article 838 be amended by adding:

> But in the case of mines and mineral deposits, where legitimate expenditures have been made for the purpose of developing known ore bodies, or mineral deposits, and ascertainable values have been added to the property, or where, as a result of development undertaken, exploration conducted, or the adaptation of improved processes, deposits or portions thereof unknown or without value at the date when the mining property was acquired, or which were not then susceptible of most efficient beneficiation, have been developed and given a value or an additional value which can be ascertained with reasonable accuracy, such value or additional value shall be regarded as surplus and shall be included in invested capital; such earned value not being "value appreciation" within the meaning of the last paragraph of Article 844.

It does not seem logical that invested capital should be limited to the original cost, and in allowing depletion on revaluations the law practically acknowledges this. It can hardly be contended for instance that the value of a large area of the anthracite lands of the Lehigh Coal & Navigation Company is represented by the "ear of corn," the consideration of a deed made over a century ago, nor that an area of timberland purchased generations ago at a nominal value is now worth no more than when it was in an inaccessible wilderness. Further, a sale may easily increase many times the invested capital in a property, but it does not change the value of the property.

If any invested capital is to be considered it seems only proper that this should represent value.

*Depletion.* The value of a property for depletion is treated as above noted in Sections 214 (a) (10) and 234 (a) (9) and by Articles 201 to 235 inclusive.

It is perhaps most logical to discuss this phase of the subject in the order in which it is treated in the "Regulations."

Article 201. "Depletion of Mines, Oil and Gas Wells" is a general statement of the base for depletion deductions. It reads in part:

> A reasonable deduction from gross income for the depletion of natural deposits and for the depreciation of improvements is permitted, based
>
> *a.* Upon cost, if acquired after February 28, 1913.

*b.* Upon the fair market value as of March 1, 1913, if acquired prior thereto.

*c.* Upon the fair market value within 30 days after the date of discovery in the case of mines, oil and gas wells discovered by the taxpayer after February 28, 1913, where the fair market value is materially disproportionate to the cost. . .

* * * *

The intent being to return the capital invested including the cost of plant and equipment and underground development not chargeable to operating expense, or the value, by the aggregate of annual depletion and depreciation deductions.

It should be noted that the cost is to be returned by the aggregate of annual allowances, not by a sinking fund with allowance of interest on the depletion and depreciation charges.

Articles 202, 203 and 204. These three articles treat of the relations of lessor and lessee in respect to depletion. The capital recoverable through depletion allowance (Art. 202) in the case of an operating owner or lessor, and (Art. 203) in the case of a lessee is defined thus:

The capital remaining in any year recoverable through depletion allowances is the sum of

*a.* The cost of the property, or its fair market value as of March 1 1913, or its fair market value within 30 days after discovery, as the case may be, plus

*b.* The cost of subsequent improvements and development not charged to current operating expenses, but minus

*c.* Deductions for depletion which have or should have been taken to date, and

*d.* The portion of the capital account, if any, as to which depreciation has been and is being deducted instead of depletion.

The surface value shall not be included, nor to the lessor any part of development costs not borne by him, or any part of discovery value. The lessee is privileged to charge costs in rents or royalties prior to operation to either operating expenses, or to capital account, when it "will form part of the capital returnable through depletion".

Article 204 states "No calculation of distribution of value between lessor and lessee exceeding the value of the property in fee simple will be permitted." This should, we think, be subject to the exception that the value based on royalties receivable is the proper and practically the only base for lessor valuations, and even though the lessee may have made a

losing bargain and the royalty prove to be excessive, the lessor is still entitled to a depletion based on the value of the lease, though this may exceed the fee simple value.

The clause requiring the lessor and lessee "to equitably apportion the allowances on the basis of their respective interests" is perfectly just, but quite impracticable in application. From long experience in the relations of lessor and lessee it seems most improbable that such apportionment could be made except through the action of the Courts, or of some commission having the necessary authority.

It seems wise not to attempt the apportionment required but to value the interests of lessor and lessee separately, using recognized methods of valuation.

The amendments of December 29, 1920 (Acts 203 and 204) state that (*b*) "The value of the equities of lessor and lesse shall be computed separately, but, when determined as of the same basic date, shall never exceed the value of the property at that date in fee simple." The lessee's equity is the value of his interest in the mineral, the lessor's in property under lease to exhaustion of the present value of the royalties or other payments as of that date, or, if not leased on the "basic date," the *bloc* value of the mineral, not to exceed the present value of royalties if subsequently leased. For term leases the value, in the absence of satisfactory evidence to the contrary, will be presumed not to exceed the present value of the lease royalties for its terms, plus the value as of the basic date of the royalties which could have been expected as of that date from the remaining mineral.

The two estates of lessor and lessee in the case of royalty "leases" of natural resources are essentially separate, as such a "lease" is a sale of mineral in place. This has been repeatedly decided by the Supreme Court of Pennsylvania—31 Pa. 475; 105 Pa. 469–472; 94 Pa. 15; 109 Pa. 583; 123 Pa. 240; 144 Pa. 613; 143 Pa. 293; 240 Pa. 234; etc.

Under these decisions the ruling (Solicitors Memorandum No. 1365), that a lease to mine coal in Pennsylvania which gave the lessee the right to mine all the coal he could remove within the period of the lease, is held not to constitute a sale

of coal in place, and the royalties received are held to be income to the lessor, does not seem to be justified.

Article 205. Where the cost is the basis for depletion (in the case of properties purchased after February 28, 1913), the Treasury properly requires full proof of the actual price paid, and watches closely for fake sales, or for concealed or misstated prices.

Article 206. The fair market value as of the basic date should be that established, assuming a willing seller and a willing buyer. "Such value may be established by proper evidence of market value, such as cost, actual sales and transfers of similar properties, market value of stock, royalties and rentals, values for capital stock tax, or local taxation, records of litigation, probate court inventory, disinterested appraisals by approved methods, and other factors."

It is a matter of common knowledge that in the case of mines and oil and gas wells, and to some extent as to timber, many of the ordinary evidences of value are not good criteria, as properties are not similar and the value of one does not indicate the value of its neighbor. Of two adjacent mines one may be worth millions and the other be a liability; of two adjacent wells, one may be a gusher and the other dry; one timber lot may be first growth pine, and the adjoining one second growth hardwood.

The other criteria suggested in the regulations are rarely equitably applicable in obtaining just valuations as between "a willing seller and a willing buyer."

This was recognized by the Treasury Department when the Subdivision of Natural Resources was organized and a careful study of the subject made and published by Mr. L. C. Graton of the Treasury, in a paper entitled "Federal Taxation of Mines," read at the Chicago Meeting, September, 1919, of the American Institute of Mining and Metallurgical Engineers. This paper it was explained had the approval of the Commissioner, and was regarded as a semi-official utterance.

Mr. Graton brought out the most important points in connection with the valuation and taxation of mines: that "increase in mine values is not unearned increment," as the

work and expenditures merely develop what was already in the ground and do not add to values, as is done to real estate by the growth of cities, improvements in transportation, etc.; that "exhaustible capital values" must be recognized; that allowance be made not only for the return of cost but for the replacement of exhausted mineral, and that "mining must be a continuing industry," as the organizations built up to work mining properties successfully are of too great economic value to be lost by the exhaustion of a single property. Mr. Graton finally points out that most of the properties have not changed ownership since March 1, 1913, and hence the valuation as of that date is the main problem.

After an able discussion Mr. Graton settles on the "Present Value of Eventual Earnings" as generally the most desirable method of valuation for this class of properties.

This method is the usual engineering method of arriving at values, and has been illuminated by the writings of Hoover (Principles of Mining, N. Y., 1909) and Finlay (Cost of Mining, N. Y., 1909) and is the only definite method of mine valuation expounded in the text books, and used by educated professional mining engineers.

Further, this has the authority of the United States Supreme Court. In *Cleveland, Cincinnati, Chicago and St. Louis Railway Co., v. Backus*, 154 U. S. 439, the Court states:

> But the value of the property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated. There is no pecuniary value outside of that which results from such use. The amount and profitable character of such use determines the value. . .

This matter was exhaustively considered by the American Institute of Mining and Metallurgical Engineers Mines Taxation Committee, above referred to, and they came to the same conclusion, which they reported as follows:

> VALUATION OF MINES. The committee arrived at the conclusion that it would be desirable to divide mineral properties into two classes, Class I and Class II.
>
> In Class I are included mineral properties in which the tonnage or other unit has been determined with reasonable accuracy.
>
> In Class II are to be included all other deposits.

As to Class I. The Committee considered methods of arriving at the present value of mineral property, and methods of depletion, and has arrived at the following conclusions.

A proper value of a mining property is the present value of the prospective net earnings taking into account probable variations in output and value, discounted by recognized sinking fund methods at a fair rate of interest with sinking fund at four per cent. interest, or by calculations by standard annuity methods. But other recognized methods of valuation acceptable to the Department may be used.

In lieu of estimated net earnings, where mining on a royalty basis is customary, royalty prices may be used in valuation, taking into consideration the trend of such prices.

No mine shall be valued on an estimated operating life exceeding forty-five years.

Ores of different grades, location, and probable time of extraction in a mining property may be classified separately and valued accordingly.

Nothing herein contained shall be understood to prescribe a method of valuing separately the equities of lessor and lessee in a mining property.

Mines in Class II may be valued in the manner prescribed for Class I but there will be a difference in the manner of determining the principal underlying factors, namely the quantity and quality of ore and the life of the mine.

In Class II sole reliance cannot be placed in the development of ore on the date of valuation, but concurrent evidence such as the habit and type of ore bodies in the mine itself, the characteristics of the district in which it occurs, the rate of development through exploration, the strength of mineralization, the stage of the operating life of the mine and any other satisfactory evidence may be used to establish a reasonable estimate of the required factors.

On the basis of present value of future earnings, we have the principles of valuation:

1. The total value of a property at any date is the value of the future earnings of such property discounted to that date.

2. The value of the mineral in the ground at any date is the total value of the property as above, less the value of the present and prospective capital expenditures for plant, development and equipment necessary to recover such mineral discounted to the same date.

To obtain this value the following factors must be determined.

1. Tonnage available. This can be estimated with a great degree of accuracy for regular deposits of coal, iron ore,

disseminated copper and the like: for less regular deposits the best information available must be used.

With respect to reserves, only such mineral as can be mined within a reasonable time should be included as available, and that all in excess of this shall be classed as "reserves unavailable." This should be carried as a separate item and under no circumstances be subject to depletion. It is suggested that a proper time limit for available mineral shall be such that its present value on an annuity basis would be ninety per cent. of the present value of an infinite amount, *i.e.*, a perpetual annuity. At six per cent. discount rate this time limit would be forty years life, and at eight per cent., thirty years, which may be properly considered as maxima. Properties with shorter lives would of course have depletion percentages calculated on the ratio of the present value for estimated life divided by years of life. The life of any property would be properly calculated on estimated average future output, taking into account probable future changes as well as past experience.

2. Life of property. This can be estimated with careful study with reasonable accuracy, and even considerable errors in total life, if this be fairly long, have but small influence on the present value.

3. Capital charges for development, plant and equipment. The value of existing plant, etc., is readily ascertainable, and the value of future necessary capital expenditures can be reasonably estimated.

4. Profit from operation. This is the undeterminable factor and can only be estimated to the best judgment of the valuing engineer.

In estimating the probable profit from operation, we believe that it is proper to consider the trend of conditions prior to 1913 and such profits after that date as could be reasonably inferred from such conditions. It is not proper to use war conditions as applying to the future, as it is most improbable that these will continue, and as the war could not have been anticipated in 1913, the valuing engineer is not justified in using war prices as a basis for valuation.

*Calculation of Valuation.* Having determined the above factors the valuation is determined by discounting to the desired date at compound interest:

1. The total net profits year by year and

2. The estimated capital expenditures year by year, to which is added the estimated value of plant, development and equipment at the basic date.

The total value of the property will be given by 1. Through 1 and 2, one determines the value of the mineral in the ground, the depletable value. The depletion charge per ton will be the value of the mineral in the ground as above divided by the available tonnage (not including reserves).

*Depletion.* This amount taken on all available tonnage estimated will return the value of the property on the exhaustion of the estimated tonnage. The method has the advantage of a known and fixed tonnage depletion, but the grave disadvantage that year by year the depletion has no standard relation to earnings. In bad years or cycles the earnings may be actually less than the depletion allowance. The result of this method is that the depletion allowance adds unduly to the cost of mineral in years of low output and excessive cost, and is negligible in years of high output and resulting low cost, so that the taxes paid are unduly irregular and in poor years there may easily be no remaining earnings for taxation.

*Suggested Method for Depletion.* It is suggested that in lieu of the tonnage depletion, this be based on earnings, following the above procedure in principle, but instead of figures based on estimated earnings the actual earnings for each year be used, and the depletion be calculated as a percentage on earnings based on the ratio of the present value of an annuity of $1.00 for the estimated life of the property, divided by the years of estimated life. This method gives practically the same ultimate result as the tonnage depletion, except that it substitutes in the calculation the actual for the estimated earnings, and varies the depletion year by year in relation to earnings. It, however, returns to the owner the actual value of his property at the basic date, based on the value of its earnings, instead of an estimated value. It results for the Government

in taxes in all years where there are any earnings, and equalizes the tax returns.

If it is objected that this method might result in excessive depletion for the war years, it could be modified by using instead of the actual earnings for these years the average earnings of the pre-war years, say from 1910 to 1916 inclusive, or the objection is probably removed by not making the ruling retroactive, as the earnings of the natural resources industries have returned to practically normal.

The percentages of earnings taken for depletion for a life of the operation from one year to the limit of calculation at six per cent. and eight per cent. interest rate are shown in the following table:

| *Years of Life* | *Per Cent. Earnings Six Per Cent.* | *Per Cent. Earnings Eight Per Cent.* |
|---|---|---|
| 1 | 94.34 | 92.59 |
| 2 | 91.67 | 89.16 |
| 3 | 89.10 | 85.90 |
| 4 | 86.63 | 82.80 |
| 5 | 84.25 | 79.85 |
| 6 | 81.96 | 77.09 |
| 7 | 79.75 | 74.37 |
| 8 | 77.62 | 71.83 |
| 9 | 75.57 | 69.40 |
| 10 | 73.60 | 67.10 |
| 11 | 71.69 | 64.89 |
| 12 | 69.87 | 62.80 |
| 13 | 68.09 | 60.79 |
| 14 | 66.38 | 58.88 |
| 15 | 64.75 | 57.06 |
| 16 | 63.16 | 55.32 |
| 17 | 61.63 | 53.64 |
| 18 | 60.15 | 52.06 |
| 19 | 58.72 | 50.54 |
| 20 | 57.34 | 49.09 |
| 21 | 56.01 | 47.70 |
| 22 | 54.73 | 46.36 |
| 23 | 53.49 | 45.09 |
| 24 | 52.29 | 43.87 |
| 25 | 51.13 | 42.70 |
| 26 | 50.01 | 41.57 |
| 27 | 48.93 | 40.49 |
| 28 | 47.87 | 39.47 |
| 29 | 46.86 | 38.47 |

| *Years of Life* | *Per Cent. Earnings Six Per Cent.* | *Per Cent. Earnings Eight Per Cent.* |
|---|---|---|
| 30 | 45.88 | 37.52 |
| 31 | 44.93 | |
| 32 | 44.12 | |
| 33 | 43.12 | |
| 34 | 42.26 | |
| 35 | 41.10 | |
| 36 | 40.61 | |
| 37 | 39.82 | |
| 38 | 39.05 | |
| 39 | 38.33 | |
| 40 | 37.61 | |

As an example, assume a property with very large reserves estimated to produce 1,000,000 tons per year, with an estimated average profit over depletion of twenty-five cents per ton, its yearly income would be $250,000, and the present value as follows:

| | | |
|---|---|---|
| Discount rate . . . . . | 6% | 8% |
| Life . . . . . . . . . . | 40 years | 30 years |
| Tonnage available . . . | 40,000,000 | 30,000,000 |
| Present value $1.00 annuity . . . . . . . | $15.046 | $11.258 |
| Present value available tonnage . . . . . . | $3,761,500 | $2,814,500 |
| Depletion per ton . . . | 9.404c. | 9.382c. |
| Depletion Per Cent. of average earnings . . | $\frac{15.046}{40} = 37.61\%$ | $\frac{11.258}{30} = 37.53\%$ |

Taking the same property with varying earnings, averaging twenty-five cents per ton, assuming regular output:

| *Year* | *Earnings Per Ton Cents* | *Depletion at Six Per Cent. Interest* | *Earnings Per Ton Cents* | *Depletion at Eight Per Cent. Interest* |
|---|---|---|---|---|
| 40 | 40 | 15.04 | | |
| 39 | 20 | 7.52 | | |
| 38 | 10 | 3.76 | | |
| 37 | 5 | 1.85 | | |
| 36 | 10 | 3.76 | | |
| 35 | 25 | 9.40 | | |
| 34 | 40 | 15.04 | | |
| 33 | 30 | 11.28 | | |
| 32 | 50 | 18.50 | | |
| 31 | 20 | 7.52 | | |
| 30 | 30 | 11.28 | 9 | 3.38 |

| Year | Earnings Per Ton Cents | Depletion at Six Per Cent. Interest | Earnings Per Ton Cents | Depletion at Eight Per Cent. Interest |
|---|---|---|---|---|
| 29 | 5 | 1.85 | 3 | 1.13 |
| 28 | 5 | 1.85 | 8 | 3.00 |
| 27 | 2 | 0.75 | 20 | 7.50 |
| 26 | 8 | 3.01 | 40 | 15.00 |
| 25 | 20 | 7.52 | 50 | 18.75 |
| 24 | 30 | 11.28 | 20 | 7.50 |
| 23 | 50 | 18.50 | 30 | 11.25 |
| 22 | 60 | 22.56 | 40 | 15.00 |
| 21 | 40 | 15.04 | 30 | 11.25 |
| 20 | 70 | 26.32 | 20 | 7.50 |
| 19 | 50 | 18.50 | 15 | 5.63 |
| 18 | 20 | 7.52 | 6 | 2.25 |
| 17 | 5 | 1.85 | 4 | 1.50 |
| 16 | 5 | 1.85 | 15 | 5.62 |
| 15 | 3 | 1.13 | 25 | 9.38 |
| 14 | 7 | 2.83 | 35 | 13.12 |
| 13 | 15 | 5.51 | 45 | 16.88 |
| 12 | 40 | 15.04 | 60 | 22.50 |
| 11 | 35 | 13.13 | 25 | 9.38 |
| 10 | 30 | 11.28 | 15 | 5.63 |
| 9 | 15 | 5.51 | 10 | 3.75 |
| 8 | 7 | 2.83 | 5 | 1.88 |
| 7 | 3 | 1.13 | 10 | 3.75 |
| 6 | 5 | 1.85 | 25 | 9.38 |
| 5 | 15 | 5.51 | 30 | 11.25 |
| 4 | 45 | 16.89 | 70 | 26.25 |
| 3 | 60 | 22.56 | 55 | 20.63 |
| 2 | 40 | 15.04 | 20 | 7.50 |
| 1 | 30 | 11.28 | 10 | 3.75 |
| TOTAL | 1000 | 374.81 | 750 | 281.29 |
| AVERAGE | 25c. | 9.37c. | 25c. | 9.37c. |

The above is based on 1,000,000 tons output per year and an average of twenty-five cents per ton, showing an agreement in total results, despite the widely varying earnings, and shows the soundness and fairness of the simple method proposed. It should be noted that, under a tonnage depletion in eleven years out of the forty, and five out of the thirty, no taxes would have been paid, as the earnings are less than the depletion.

With this proposed plan the division of interest between lessor and lessee would be absolutely simple, as the royalty

and profit (over royalty) would each be depleted on the same percentage fixed on the estimated life of the roperty.

It must be clearly understood that the above "Suggested Method for Depletion" is the suggestion of the Engineers Committee of the National Coal Association, and has not been accepted by the Treasury.

*Discount Rate.* The question of the proper discount rate to be used to obtain present value is a mooted one; and, under various conditions, rates from ten per cent., or even more, down to four per cent., and under, have been used by competent authorities, while the need of higher percentages is recognized in doubtful cases, as in mines where the amount of mineral remaining is not ascertainable. In the case of mines in well known territory the six per cent. discount rate is considered proper. This is the legal rate of interest, and while it may be contended that a business like mining should yield a higher rate of profit, the experience of years shows that the average profit in most mining ventures is below rather than above this percentage.

It seems that, at least for taxation purposes, the six per cent. figure should be used. This has the authority of a standard legal rate, and anything else, except to discount uncertainties, must be a mere assumption.

While six per cent. is believed to be proper in most cases it is recognized that a higher discount rate may be justly used where the extent or continuity of the deposit is doubtful.

Much of this has been reorganized in the amended regulations of Dec. 29, 1920, in which this article reads as follows:

Article 206. "Determination of Fair Market Value of Mineral Property."

(*a*) Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will lend due weight and consideration to any

and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purpose of the capital stock tax, valuation for local or state taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, disinterested appraisals by approved methods such as the present value method and other factors.

(*b*) To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the property. The factors are (1) the total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed, (2) the average quality or grade of the mineral reserves, (3) the expected percentage of extraction or recovery in each process or operation necessary for the preparation of the crude mineral for market, (4) the probable operating life of the deposit in years, (5) the unit operating cost, *i.e.*, cost of production exclusive of depreciation and depletion, (6) expected average selling price per unit during the operating life, and (7) the rate of profit commensurate with the risk for the particular deposit. When the deposit has been sufficiently developed these factors may be determined from past operating experience. In the application of factors derived from past experience full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, costs of production and selling price of the product marketed during the expected operating life of the mineral deposit.

(*c*) Mineral deposits for which these factors may not be determined with reasonable accuracy from past operating experience may, with the approval of the Commissioner, be valued in a similar manner; but the factors must be deduced from concurrent evidence, such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits in the property itself, the intensity of mineralization, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the property, and other evidence tending to establish a reasonable estimate of the required factors.

(*d*) Mineral deposits of different grades, locations and probable dates of extraction in a mineral property shall be valued separately. The mineral content of a deposit should be determined in accordance with Article 208 in the case of mines, with Article 209 in the case of oil wells, and with Articles 211 and 212 in the case of gas wells. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or definitely adopted at the basic date for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at

the rate determined as above. The operating cost comprises all current expense of producing, preparing and marketing the mineral product sold, exclusive of Federal Income, War Profits and Excess Profits Taxes, allowable capital additions as defined in Article 222, and deductions for depreciation and depletion, but including cost of repairs and replacements necessary to maintain the plant and equipment at its rated capacity and efficiency. This cost of repairs and replacements is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returned to the taxpayer free from tax. In general no estimates of these factors will be approved by the Commissioner which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

(*e*) The product of the number of units of mineral recoverable in marketable form by the difference between the selling price and the operating cost per unit is the total expected operating profit. The value of each mineral deposit is then the total expected operating profit from that deposit reduced to a present value as of the basic date at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at the basic date of the depreciable assets and of the capital additions, if any, necessary to realize the profits.

Article 207. Once the value of a property is fixed, re-appraisals are not allowed, though a revision of the unit values is required if changes from estimates are determined. This appears to be strictly a "ruling" as we can find nothing in the law requiring such a drastic interpretation.

Article 208. "Determination of Quantities." Quantities are required to be estimated as of March 1, 1913. In making such an estimate any engineer would make his estimate up to the date of examination, and reduce to the basic date by adding the units produced between the basic date and the date of examination.

While perhaps technically no information not available March 1, 1913, is supposed to be used in such estimates, in this case, as in the case of estimating profits, no engineer would, or should be asked to stultify himself by using estimates based on what he may try to imagine he would have thought on March 1, 1913, but which on information available when his estimate was actually made he knows to be incorrect.

The regulations provide that:

The estimate of the recoverable units of ores or minerals for the purpose of depletion shall include:

*a*. The ores and minerals "in sight," "blocked out," "developed" or

"assured" in the usual or conventional meaning of these terms in respect to the type of deposit, and may also include

*b.* "Prospective," or "probable" ores and minerals (in the same sense), that is, ores and minerals that are believed to exist on the basis of good evidence, although not actually known to occur on the basis of existing development; but "probable" or "prospective" ores and minerals may be computed for purposes of depletion only as extensions of known deposits into undeveloped ground, as to quantity and richness only on geological evidence of high degree of probability.

Article 209. "Determination of Quantity of Oil in Ground." An estimate is required of the probable recoverable oil as of March 1, 1913, or at the date of purchase, or within thirty days after discovery. But the estimate, if subsequently proved clearly erroneous, may be revised with the approval of the Commissioner.

This is undoubtedly due to the supposedly less accurate estimates of oil as compared with minerals. As a matter of fact in many cases one is no more accurate than the other, and it would be only just to extend this section to mines.

Article 210. "Computation of Deduction for Depletion of Mineral Deposits."

(*a*) Depletion attaches to the annual production "according to the peculiar conditions of each case" and when the depletion actually sustained, whether legally allowable or not, from the basic date, equals the cost or value on the basic date plus subsequent allowable capital additions, no further deduction for depletion will be allowed except in consequence of added value arising through discovery or purchase (See Articles 202, 203, 204, and 222).

(*b*) When the value of the property at the basic date has been determined, depletion for the taxable year shall be determined by dividing the value remaining for depletion by the number of units of mineral to which this value is applicable and by multiplying the unit value for depletion, so determined, by the number of units sold within the taxable year. In the selection of a unit for depletion preference shall be given to the principal or customary unit or units paid for in the product sold.

Article 211–212. "Depletion of Gas Wells." Rather specific directions for computing depletion for gas wells are given, including detailed directions for determining pressures; these are to be applied to the formula:

The quotient of the capital account recoverable through depletion allowances to the end of the taxable year, divided by the sum of the

pressures at the beginning of the year less the sum of the pressures at the time of expected abandonment (which quotient is the unit cost), multiplied by the sum of the pressures at the beginning of the taxable year plus the sum of the pressures of new wells less the sum of the pressures at the end of the tax year, equals the depletion allowance.

Article 213. Where figures are unavailable tentative estimates may be made to be replaced by later estimates.

Articles 214. "Computation of Depletion Allowance for Combined Holdings of Oil and Gas Wells." This section allows a combined report and general depletion of all holdings.

Article 215. "Depletion of Mines Based on Advance Royalties." When under a lease a minimum royalty, permitting the removal of a corresponding number of units of mineral, is paid, the lessor may claim depletion for the units thus paid for even if not mined, but if these are mined later no further depletion is allowed; but in the event that the property is returned or re-possessed, an amount equal to the aggregate deductions for depletion for mineral still in the ground will be deemed income to lessor and returned as such for the year the property is repossessed.

In our opinion this also applies to depletion for the lessee.

Article 216. Book accounts are required, in which the value shall be entered and depletion charged. The Court, in *Forty Fort Coal Co. v. Kirkendall, Collector* (223 Fed. 704), decided that depletion might be properly taken regardless of book accounts.

Articles 217, 218. Where depletion is claimed, and in fact where any deductions in the case of natural resources are claimed, the taxpayer is required to fill out a statement, in the form of a rather complicated questionnaire. These questionnaires have been drawn to furnish all possible information which may be of use in determining values, depletion, depreciation, etc. They are properly made voluminous, and call for very much data not in the possession of most taxpayers. These should be filled out as far as practicable. As a general rule only data necessary in determining the claims made by a taxpayer are required. Ancient history and data not affecting the taxpayers claim are not needed and the blanks for this need not be filled. For instance, the questionnaire requires, "Cost of

property." In the case of an estate the accepted answer was "inherited"—"unknown." While the questionnaires apparently require a brief of title of all property the Treasury seems to be entirely satisfied with the most recent transfers.

In general the Treasury is most reasonable and does not require nor expect special research to make out their questionnaires.

Article 219. "Discovery of Mines."

(*a*) To entitle a taxpayer to a valuation of his property for the purpose of depletion allowances, by reason of the discovery of a mine on or after March 1, 1913, the discovery must be made by the taxpayer after that date and must result in the fair market value of the property becoming disproportionate to the cost. The fair market value of the property will be deemed to have become disproportionate to the cost when the newly discovered mine contains mineral in such quantity and of such quality as to afford a reasonable expectation of return to the taxpayer of an amount materially in excess of the capital expended in making such discovery plus the cost of future development, equipment, and exploration.

(*b*) For the purpose of these sections of the Act a mine may be said to be discovered when (1) there is found a natural deposit of mineral, or (2) there is disclosed by drilling or exploration, conducted above or below ground, a mineral deposit not previously known to exist and so improbable that it had not been, and could not have been, included in any previous valuation for the purpose of depletion, and which in either case exists in quantity and grade sufficient to justify commercial exploitation. The discovery must add a new mine to those previously known to exist and cannot be made within a proven tract or lease as defined in paragraph (f) *infra*.

(*c*) In determining whether a discovery entitling the taxpayer to a valuation has been made, the Commissioner will take into account the peculiar conditions of each case; but no discovery, for the purposes of valuation, can be allowed, as to ores or minerals, such as extension of known ore bodies, that have been or should have been included in "probable" or "prospective" ore or mineral, or in any other way comprehended in a prior valuation, nor as of a date subsequent to that when, in fact, discovery was evident, when delay by the taxpayer in making claim therefor has resulted or will result in excessive allowances for depletion.

(*d*) The value of the property claimed as a result of a discovery must be the fair market value, as defined in Article 206, based on what is evident within thirty days after the commercially valuable character and extent of the discovered deposits of ore or mineral have with reasonable certainty been established, determined or proved.

(*e*) After a *bona fide* discovery the taxpayer shall adjust his capital and depletion accounts in accordance with Articles 206, 208, and 210, and shall submit such evidence as to establish his right to a revaluation,

covering the conditions and circumstances of the discovery and the size, character and location of the discovered deposit of mineral, the value of the property at the prior basic date, the cost of discovery, and its development, equipment and exploitation, its value and the particular method used in the determination.

(*f*) In the case of a mine, a "proven tract or lease" includes, but is not necessarily limited to, the mineral deposits known to exist in any known mine at the date as of which such mine was valued for purposes of depletion, and all extensions thereof, including "probable" and "prospective" ores considered as a factor in the determination of their value or cost.

The A. I. M. E. Committee suggested in addition:

(*g*) The proving by the taxpayer of the commercial value of a mineral or ore deposit by the development, refinement or perfection of known methods or processes of mining or metallurgy or both or by the discovery and application of new methods of mining and metallurgy at a cost materially less than the commercial value of the deposit thus proven or created. The estimation of the value of the deposit must be made as of a date not later than thirty days after the commercial value of the deposit has thus been proven.

Further ore discovered either by further development or exploration, whether this ore be an extension of a previously known ore body, or a new ore body or by improved processes of treatment, and not included within the previously estimated value or estimated life of the mine, may be valued for depletion purposes following such discovery or discoveries.

The law is perfectly clear in its thirty days, but all engineers know that this limit is much too short. Six months or a year would be better.

As a matter of fact, however, the discovery is not really consummated until a reasonable amount of profitable mineral has been proved, so that the actual date of discovery is not the date of finding an outcrop, or putting a drill hole through ore, or even exposing valuable mineral in underground workings. The regulation states clearly that the discovery must be of a *commercially valuable deposit*. Hence the date of discovery will be very hard to determine, and in the final analysis will rest largely in the discretion of the Treasury.

Articles 220–221 (Revised.) The law provides that taxpayers who discover oil and gas wells on or after March 1, 1913, may, under the circumstances therein prescribed, determine the fair market value of such property at the date of discovery or within thirty days thereafter for the purpose of ascertaining allowable deductions for depletion. Before such valuation

may be made the statute requires that two conditions precedent be satisfied:

1. That the fair market value of such property (oil and gas wells) on the date of discovery or within thirty days thereafter became materially disproportionate to the cost, by virtue of the discovery, and
2. That such oil and gas wells were not acquired as the result of purchase of a proven tract or lease.

The regulations provide that a discovery is made when there is either a natural exposure or a drilling disclosing oil or gas in sufficient quantities to at least afford a reasonable expectation of returning the capital invested in the well.

A proven tract is considered to be a square of 160 acres, regardless of private boundaries, with a well producing oil or gas in commercial quantities as its center, the lines of the square parallel to established section lines, or lacking these the sides run, north, south, east and west. But an area immediately surrounded by proven areas and with favorable geologic structure is to be regarded as proven.

The property to be revalued is the "well," comprising the actual drill hole, the surface necessary for operation, and the gas or oil content of the zone discovered to the limit of the property, but not exceeding the 160 acre square.

To revalue after March 1, 1913, a discovery must be made after that date which results in the fair market value of the property being materially in excess of its cost, or value as of March 1, 1913, plus the cost of exploration and development work to the time of discovery.

Full proof of discovery is required, details of drilling, and of out-put, copy of records showing cost of property, and a statement of method of valuation—really such proof as any court or business man would properly demand.

Article 222 (Revised.) "Allowable Capital Additions in Case of Mines."

(*a*) All expenditures for development, rent and royalty in excess of receipts from minerals sold, shall be charged to capital account recoverable through depletion, while the mine is in the development stage. Thereafter any development which adds value to the mineral deposit beyond the current year shall be carried as a deferred charge and

apportioned and deducted as operating expense in the years to which it is applicable.

(*b*) All expenditures for plant and equipment shall be charged to capital account recoverable through depreciation, while the mine is in the development state. Thereafter the cost of major items of plant and equipment shall be capitalized but the cost of minor items of equipment and plant, necessary to maintain the normal output, and the cost of replacement may be charged to current expense of operation.

It is somewhat difficult properly to draw the line between capital charges and operating costs as indicated above. The clause "necessary to maintain a normal output" indicates that the line may be drawn about as suggested below.

*Capital Charges.* There should be charged to capital account:

*a.* The value of the mineral in the ground;
*b.* The value of the development;
*c.* The value of mechanical equipment inside and outside and
*d.* The value of plant, buildings, dwellings, water-works, sewerage, roads, railroads, plant facilities and the like. All to *attain* but not to *maintain* output.

*Operating Charges.* There should be charged to operation all costs of production, all development, plant and equipment necessary to maintain output. All overhead expenses necessary in carrying on the business, all local taxes, depletion and depreciation.

*Development.* The cost of the development of a property to its intended output is properly chargeable to capital. All further development to maintain output is properly operating expense. A mine may be considered developed when there are sufficient working places to produce the designed output, and sufficient entry work in progress to replace exhausted areas and maintain output. Sufficient advance development should be maintained to assure beyond question the maintenance of output under unfavorable conditions.

*Plant and Equipment.* All plant and equipment necessary to bring the property to capacity is properly a capital charge. All additions, renewals and extensions necessary to maintain output should be charged to operation.

*Deductions from Income.* Interest, U. S. income and excess profits taxes, dividends, additions to surplus, capital expenditures made from income, and charitable contributions by corporations are under the present laws not chargeable to operating expenses, but are included in taxable income.

In this connection losses must be considered [Art. 214 (a) (4) (5) (6) and (8) ]. These include the voluntary removal of buildings or scrapping of equipment, etc., and losses by obsolescence.

In some cases heavy claims for depreciation have been made in error and refused, when the actual costs were losses due to removal of buildings, and scrapping of machinery, which if claimed would have been allowed.

Art. 223. "Charges to Capital and to Expense in the Case of Oil and Gas Wells." Incidental expenses, and the cost of drilling unproductive wells may, at the option of the taxpayer, be deducted as operating expense, or charged to capital and be subject to depletion. The election once made cannot be changed.

Art. 224. "Depletion of Mine Improvements." At the option of the taxpayer depletion may be made to include plant and equipment charged to capital, at a rate determined by the rate of exhaustion of the mineral, or a depletion account for mineral and a depreciation account for plant and equipment may be used. In general the latter is better accounting and more satisfactory in application.

The depreciation may be based on either physical life, "the estimated time such plant, or unit, when given proper care and repair, can be continued in use despite physical deterioration, decay, wear and tear," or economic life, "the estimated time during which the plant or unit may be utilized effectively and economically for its intended purpose, and may be limited by the life of the property . . . but can never exceed the physical life."

Art. 225, 226. "Depreciation of Improvements in Oil and Gas Wells." Depreciation on capital charges for equipment to reduce these to scrap values at the termination of the estimated life of the property is allowed, even though such life be shorter than the probable normal life of such equipment.

Returns prior to 1916 need not be re-opened, unless the deductions are decided to be unreasonable.

In general depletion and depreciation are intended to return the value of the property, less any scrap value or remainder value at the termination of the life of the property, and both may be figured on the probable life of the property even though a short life may materially increase the allowances.

*Timber.* The regulations in regard to depletion of timber properties follow in general the lines of those for mines and oil and gas.

Art. 227, 228. "Depletion and capital recoverable" from depletion are similar to the corresponding regulations for mines.

Art. 229. "Computation of Allowance for Depletion." This is based on the feet cut during the year at the unit cost of March 1, 1913, or the date of acquisition if later.

This differs from other depletion rules in the use of unit value rather than the total value of the property. No revaluation of stumpage is allowed (Art. 230), but the unit value of stumpage may be changed if it is found inadequate or excessive to return the fair market value of the timber as of March 1, 1913.

Art. 231. "Charges to Capital and to Expense in the Case of Timber:"

> In the case of timber operations all expenditures for plant, equipment, development, rent and royalty prior to production, and thereafter all major items of plant and equipment, shall be charged to capital account for purposes of depreciation. After a timber operation and plant has been developed and equipped to its normal and regular output capacity, the cost of additional minor items of equipment and the cost of replacement of minor items of worn-out and discarded plant and equipment may be charged to current expenses of operation.

Art. 232. The improvements charged to capital may be included in the stumpage depletion or depreciated separately.

Art. 233. Complete statements giving full data are required of property owners claiming depreciation or depletion.

Art. 234. The fair market value of a tract of timber as between a willing seller and a willing buyer as of March 1, 1913, must be based on the property as it existed at that date, regardless of subsequent changes.

Art. 235. The quantity of timber as of March 1, 1913, or on date of acquisition, must be estimated in detail, in accordance with the practice of the basic date: adjustments of rate but not of total value may be made if later evidence shows the original estimate to have been incorrect.

Art. 236, 237. Separate blocks of timber to be kept in separate accounts, and book accounts required if depletion or depreciation is claimed.

*Conclusion.* The foregoing review of the laws and regulations is necessarily incomplete, but it is hoped full enough to give a reasonable outline of this very technical branch of income taxation.

The Commissioner is honestly endeavoring to administer the law with justice and with common sense, but the subject is difficult, involving technical knowledge and experience, hardly to be expected of the rank and file of Treasury employees, and not attainable at the salaries paid even to the heads of departments, except at a great personal sacrifice, and the engineers who have handled the difficult work of the Natural Resources Subdivision have done so at such great personal sacrifice as to put the business community very deeply in their debt.

Accounting. Many of the industries, as the bituminous and anthracite operators, the Lake Superior Iron Region, and others, have appointed competent committees and have adopted uniform standard accounting systems, which generally have received the approval of the Treasury, and the general use of which greatly simplifies the work of properly reporting earnings, and further permits actual comparisons of costs, which was impossible with the widely varying accounting or rather lack of accounting existing prior to the imposition of the income and excess profits taxes.

The law as it stands involves the use of much data not generally available, and in many instances requires technical services of a high grade, to ascertain the figures and present them properly. It would seem that practically the same results could be obtained from a much simplified law.

The following lines of changes might well be considered:

First.—Invested Capital. Article 838 should be amended by adding:

But in the case of mines and mineral deposits, where legitimate expenditures have been made for the purpose of developing known ore bodies, or mineral deposits, and ascertainable values have been added to the property, or where, as a result of development undertaken, exploration conducted, or the adaptation of improved processes, deposits or portions thereof unknown or without value at the date when the mining property was acquired, or which were not then susceptible of most efficient beneficiation, have been developed and given a value or an additional value which can be ascertained with reasonable accuracy, such value or additional value shall be regarded as surplus and shall be included in invested capital; such earned value not being "value appreciation" within the meaning of the last paragraph of Article 844.

Second.—Depletion. As the fair value of a property at any date is the present value of the future earnings discounted to that date, depletion could logically be taken as a percentage of earnings for each year, such percentage being the present value of an annuity of $1.00 per year for the estimated life of the property, divided by the number of years estimated life. This would return the actual value of the property as of the basic date, as the actual earnings year by year, instead of the estimated earnings, would be used in the calculations of value.

The maximum life should be limited as hereinbefore suggested, and interest rates fixed for the different industries.

This leaves only the probable life as a factor to be determined and errors in that would not be serious, as when one hundred per cent. depletion had been paid the deduction for depletion would cease.

Third.—Value. If the foregoing is not acceptable the values of properties for depletion purposes should be redetermined at regular intervals. It is only just to put properties remaining in one control on a parity with those with changing control, which benefit in depletion by having paid the going value at the time of their purchase.

Fourth.—Depreciation. The present depreciation accounting should be simplified. This might be accomplished by determining for each class of equipment a standard life, then for each subdivision of industry the average or normal percentage of each class used, thus calculating, as a weighted

average, the general life of all equipment in the form of a percentage, this to be used as a base, subject to correction for short-lived properties.

Fifth.—Capital Charges. A more definite line should be drawn between operating costs and capital charges. This could be done by changing the present regulation (Article 222) to read:

*Charges to Capital and to Expense in the Case of a Mine.* In the case of mining operations all expenditures for plant equipment, development, rent and royalty, and all carrying charges prior to production, and thereafter all major items of plant and equipment to *increase* but not to *maintain* production, shall be charged to capital account for the purpose of depletion and depreciation. After a mine has been developed and equipped to its normal and regular output capacity, however, the cost of additional development and items of equipment and plant including mules, motors, mine cars, trackage, cables, trolley wire, fans, small tools, etc., necessary to maintain the normal output because of increased length of haul or depth of working consequent on the extraction of mineral, and the cost of replacements of these and similar items of worn-out and discarded plant and equipment, may be charged to current expense of operations, unless the taxpayer elects to write off such expenditures through charges for depreciation.

This is only just, as such increase in equipment to maintain but not to increase output does not increase the value of the property, but only increases expense, and the capital account should not be burdened with such charges.

Sixth.—Discovery.—A broadening and clarifying of the definitions and regulations regarding "discovery." This might well be accomplished by accepting the suggestion of the A. I. M. E. Committee:

1. That Article 219, of Regulations 45, as revised, be amended by inserting after the words "proving and development" at the end of the first paragraph thereof, a new sub-division to be known as sub-division (*c*), to read as follows;

(*c*) the proving by the taxpayer of the commercial value of a mineral or ore deposit by the development, refinement or perfection of known methods or processes of mining or metallurgy, or both, or by the discovery and application of new methods of mining or metallurgy at a cost materially less than the commercial value of the deposit thus proven or created. The estimation of the value of the deposit must be made as of a date not later than thirty days after the commercial value of the deposit has thus been proven.

2. Further ore discovered either by further development or exploration whether this ore be an extension of a previously known ore body or

a new ore body or by improved processes of treatment, and not included within the previously estimated value or estimated life of the mine may be valued for depletion purposes following such discovery or discoveries.

In general such modifications of the law are desirable as tend to its simplification, and reduce the labor of preparing and of checking up returns, and which reduce to a minimum the possibility of misunderstanding or dispute as to what is to be returned as net income.

# RELIEF PROVISIONS AND TREASURY PROCEDURE ON APPEALS

BY

P. S. Talbert

Broadly speaking, any of the deductions or credits which have the effect of reducing taxes might be considered to be relief provisions in these days of high taxes, but I shall confine my application of the term to those provisions not contained in previous income tax laws and inserted in the Revenue Act of 1918 for the undoubted purpose of affording special relief, in view of the high rates of war taxes, against hardships definite or indefinite, likely to arise either from anticipated business conditions or operation of the law in certain cases.

In passing, I might call attention here to the fact that much of the intricacy of the law and most of the complexity of the forms, about which there has been loud complaint, are due to the numerous relief provisions and the necessity for providing on the form-blanks opportunity for every taxpayer to take advantage of any of them to which he is entitled.

These relief provisions fall naturally into two classes, those authorizing specific deductions or credits under certain conditions and those of an administrative nature.

In the first class are the deductions for amortization of cost of war plant or facilities; for inventory losses which it was anticipated would occur in 1919; for net losses sustained in 1919; for revaluation for depletion purposes of oil and gas wells and mines; for limitation of the tax on profits made through the sale of mines and oil and gas wells by the discoverer; credits for foreign income and profits taxes paid against similar taxes due the United States, and exemption of corporations engaged in the mining of gold from the profits taxes on income from that source.

Falling in the second class are the provisions authorizing the crediting of overpayments in previous years against any income or profits taxes due the United States; limiting the collection of additional taxes to a period within five years after they were originally due, by forbidding suits after the expiration of five years from the due date of the return except in case of fraud (the previous rule, founded on the principle that the statute of limitations does not run against the Government, being that taxes could be collected at any time by suit, even though the period during which assessment might be made had passed); limiting the profits tax to certain percentages designed to benefit the small corporation; most important of all, perhaps, the authority to determine the amount of the profits tax under certain conditions by comparison with representative concerns and the creation of an "Advisory Tax Board" to whom the taxpayer might appeal for a reversal of decisions which he believed to be erroneous or unjust.

The more important provisions of the first class, such as amortization and inventory losses, have been covered in detail in previous papers, and of them I will only say that two at least, which at the time the act was passed were expected to afford substantial relief in many cases, have been practically inoperative because the conditions they were designed to relieve did not materialize, and since they were limited to the year 1919, they are not available for relief in 1920, when those conditions have arisen in a number of important industries. I refer to the provisions for throwing back or forward as a deduction allowable in the previous, or succeeding year, if necessary, net losses from operations in 1919 and inventory losses sustained in 1919, through shrinkage during that year in the value of closing inventories of 1918. The anticipated shrinkage in values and decline in profits appears to have taken place in 1920 instead of 1919, and consequently the claims for net loss have been few in number, and the Treasury's interpretation of the inventory-loss provision, holding that the inventory must be considered as a whole, practically eliminated that from consideration, as there were few instances where it could be shown that there had been in 1919 a substantial loss in

disposing of the closing inventory of 1918 taken as a whole.

Perhaps there was no one thing which so exasperated the taxpayer and violated his sense of fairness and justice as that practice of the Treasury, necessitated under former laws, requiring him to pay at once the whole amount of any additional tax found due for any given year upon the audit of his books, although the same audit might disclose and the Treasury concede that for another year he had overpaid his taxes, for which overpayment he was told he might make a refund claim, usually resulting in a wait of a year or more for his money.

This was cured in the Revenue Act of 1918, by authorizing the filing of a claim for credit of any overpayment of tax against any tax due from him, resulting in his paying in cash only the net balance against him. There is some misapprehension as to the effect of the acceptance of such a claim by the Collector, so it may be well to state that the filing of a claim for credit or its acceptance by the Collector does not in itself extinguish any liability. It merely has the effect of a claim for abatement, serving by forbearance of the Collector to delay payment until acted on by the Commissioner. If allowed, it of course wipes out an equal amount of liability; if disallowed, collection is made of the amount in suspense with interest.

Another important administrative relief provision is that which in effect places the taxpayer and the Government on an equal footing with respect to the bar of limitations, by providing that no assessment shall be made or suit instituted by the Government after five years from the due date of the return, except in fraud cases, and that no claim for refund shall be considered unless made within the same period.

It will be noted that time begins to run from the same date against both the taxpayer and the Government, and an awkward situation might arise under a literal interpretation of this statute standing alone, since if the Government waits until the last few days of the period before making assessment, the taxpayer's five years may have elapsed before he is even called on for payment. This possibility has been averted by the Treasury's very fair ruling that the statute was not intended to abrogate the taxpayer's right under the Revised Statutes to

make claim for refund at any time within two years after payment.

The determination of the profits tax by comparison with representative concerns, required or authorized by Sections 327 and 328 of the law, corresponding with Section 210 of the Revenue Act of 1917, as interpreted by the Treasury, gives rise to one of the most difficult and unsatisfactory situations in the administration of the law, since the result depends entirely on the comparatives used, and the selection of comparatives is wholly a matter of judgment.

The Treasury has endeavored to meet the situation by classifying all industry into major divisions, such as manufacturing, trading, financial, transportation, etc. These divisions are subdivided, manufacturing, for example, into concerns manufacturing textiles, iron and steel, etc., the process of subdivision being repeated until the groups are comparatively narrow. It is when we come to compare corporations belonging in the same final group that the difficulty begins. There are so many factors entering into the problem that the decision as to which should be used in the final analysis is more or less arbitrary. When the ground for applying these sections has been some abnormality of income or invested capital, my own method of approach has been to figure out what the tax would have been had the abnormality not existed, regarding the amount so found as the equitable tax, and then selecting comparatives that would result in approximately this figure. This, however, is not always practicable.

Since to disclose the names of the comparatives used would in effect disclose information as to their taxes, which the law forbids, it is impossible in many instances to satisfy the taxpayer that he has been fairly dealt with.

Perhaps it is a misuse of terms to speak of the Committee on Appeals and Review as one of the relief provisions of the law, since, technically, it is not specifically authorized by the law itself, but is a creation of the Treasury to take the place of the Advisory Tax Board provided by the law for a limited period of time.

I can perhaps best give you a comprehensive view of the

need for such an organization by sketching for you as a background something of the development of internal taxation as imposed by the federal government. Most of us who have had no occasion to consider or study the history of taxation, are, I think, prone to regard internal revenue taxes as something which, like poverty, we have always had with us, as we surely always will have in the future. Such, however, is not the case, and for long periods in the history of the country, there have been no internal federal taxes imposed.

Excluding proceeds of borrowings, as not being in a proper sense revenues at all, and also excepting postal revenues, and some minor miscellaneous sources of income, the revenues of the federal government are derived from two sources; duties on the importation of foreign merchandise into the country, and internal taxes, the latter being divisible into two classes, direct taxes and indirect taxes.

Direct taxes have been specifically imposed only twice during the history of the nation, and as they must be apportioned among the states according to population and not according to wealth, they are not likely to be resorted to again.

The first internal tax was an excise tax on distilled spirits imposed by an Act of Congress passed early in 1791. This act met with much objection and opposition, which was carried to such an extent that in 1794 it was deemed necessary to call out the militia of four states to the number of 15,000 men, to put down the so-called "Whisky Rebellion" in Pennsylvania.

This act was followed by other laws passed in 1794, levying taxes on carriages used as conveyances, on licenses for selling wines and foreign distilled spirits, on snuff and sugar refined in this country, and in 1797, imposing certain documentary stamp taxes.

In 1802, all of these taxes were repealed and from that year until following the war of 1812, the country got along without internal federal taxes. In 1813, on account of the expense incurred during the war of 1812, most of the taxes repealed in 1802 were reimposed with some additional ones. These taxes remained in force from 1813 to 1817, when they were again repealed, and then followed a long period during which the

revenues from imports sufficed to meet the revenue needs of the country, and during which it was free from internal revenue bedevilment. This happy condition lasted indeed until the outbreak of the Civil War made it necessary to use every possible available means for raising the money necessary to carry on the war. In 1861, an act was passed levying a direct tax of $20,000,000, and also providing for an income tax. The income tax features of this act were never put in force, and the officers provided for by it were never appointed, as Congress in 1862 passed a much more comprehensive scheme of taxation. This Act of 1862 provided for the creation and organization of an internal revenue service, which has existed with some modifications to this day.

This law was very broad in its scope, providing for an income tax as well as taxes on most occupations and commodities capable of yielding revenue. With some amendments and modifications, it remained in force for several years, and some of the commodities taxed under it, as for instance, distilled spirits, fermented liquors, cigars and tobacco, have borne the principal burden of internal revenue taxation up to very recent times.

The income tax provisions of this act, which served as a basis for the drafting of the later Act of 1913, were continued in force until 1872. Curiously enough, this income tax does not appear to have been attacked as unconstitutional, at least on the grounds which resulted in the well known Supreme Court decision in the Pollock case, holding the similar provisions of the Act of 1893 invalid as being in effect direct taxes not levied under the rule of apportionment, as required by the Constitution. Comparatively little litigation appears to have resulted from this act, although one decision of the Supreme Court under it, that rendered in the case of *Gray v. Darlington*, has remained as more or less of a stumbling block to the lawyers of today in construing recent legislation.

By 1872, most of the internal taxes except those on liquors and manufactures of tobacco had been repealed and with the exception of a short period following the Spanish-American War of 1898, those commodities furnished the prin-

cipal sources of internal revenue for some forty years or more.

Although an excise tax measured by income was imposed in 1909, on the privilege of doing business as a corporation, it was not until after the constitutional amendment authorizing the levy of an income tax without apportionment was ratified, in 1913, that income taxes became an important feature of internal taxation.

I have gone at such length into the history of the development of internal revenues for the purpose of emphasizing the fact that Congress has in recent years adventured into practically virgin fields of taxation by the passage of laws which have been on the statute books so short a time that there is no established body of authoritative court opinion to serve as a guide for the determination of many of the difficult and intricate questions which daily arise in connection even with the income tax law, not to speak of these inherent in the even more difficult field of profits taxes. Even such fundamental questions as "What is income?" and "When does it become taxable?" are still questions which give rise to much dispute and argument, for the reason that the principles governing their determination are not yet clearly and authoritatively established.

It must be remembered, too, that the Government is endowed with very broad powers of summary process in the collection of its revenues. Its policy is and always has been to collect first and litigate afterwards, in the case of disputes with the taxpayer. The Collector is charged with the amount of any assessment sent to him and is liable under his bond as Collector for the amount, if he fails to use due diligence in collection. If a tax is not paid within ten days after notice and demand, he is authorized to issue a warrant of distraint, which has the force and effect of an execution upon a judgment. Under it, he may seize and sell at public auction any property he can find belonging to the taxpayer, in satisfaction of the tax, and under express provision of the statute, no court can interfere to stay his action. The only recourse the taxpayer has in such case is to sue for the recovery of the amount collected. It has been said that a redress is provided by the courts

for every wrong, but this is possibly the exception which proves the rule. While real estate, if sold by the Collector, may be redeemed within a certain period, if personal property is sold, it is gone beyond redemption, and even if the tax was not properly levied, the taxpayer can recover in the court only the amount for which it sold, which may have been far less than its real value.

I think I have said enough to show the absolute need of some provision whereby the taxpayer may be assured of a thorough and painstaking review of his case, in the event of differences of view between himself and his counsel and the assessing officers, before recourse is had to such drastic measures for collection, and it was to meet this need that the Committee on Appeals and Review was created.

In order to function successfully, it is essential that the Committee deserve and win the confidence of the tax-paying public, not only in its ability, but in its fairness and impartiality as well.

Its personnel was accordingly selected from those officers of the Bureau who have not only had long experience and the greatest possible familiarity with tax problems, but who have also demonstrated that they have the judicial temperament and can be relied on to reach fair and impartial conclusions regardless of the result.

Further, to avoid any suggestion of prejudice or influence in favor of the views or position of the Income Tax Unit, the Committee was taken out of its jurisdiction, and is responsible only to the Commissioner and Secretary of the Treasury.

Shortly before leaving the service, being curious as to exactly what extent the Committee had afforded relief to the taxpayer in actual practice, I had an examination made of all of its recommendations, and found that in forty per cent. of all the cases handled, it had reversed the Unit, and allowed the taxpayer's claims in full; in thirty-seven per cent. it had supported the Unit and rejected the taxpayer's contentions; and in twenty-three per cent. it had in part supported the taxpayer's claims and in part the views of the Unit. This is sufficient, I think, to refute any suggestion that the

Committee is unduly prejudiced in favor of the Unit.

The Committee consists of five members, three of whom have given their entire time to its work, and the other two, the Head of the Internal Audit and Head of the Review Division, sit in on the final determination of cases. The latter two are not *ex-officio* positions, but the men occupying them were selected because of their peculiar fitness for the work. Upon the recent resignation of Mr. Murphy, Head of the Internal Audit Division, his place on the Committee was filled by a member who will give his entire time to the work, making four now so engaged.

The Committee has practically no formal set rules of procedure, except (1) that it will not consider an appeal until the Income Tax Unit has rendered a final decision, so that the appellant has something definite from which to appeal, and (2) that any facts upon which the appeal is based must be succinctly stated in writing and sworn to. The procedure after an appeal is duly filed is informal, the object of the Committee being to get at the real facts and the amount of tax rightly due.

The routine of handling the work is as follows: The appeal in writing, stating the decision of the Unit which is objected to and from which appeal is taken, may be filed either with the Unit or directly with the Committee's secretary. In the latter case, a card record is made and the Income Tax Unit notified that an appeal has been taken and requested to forward all papers, with such memoranda explaining its position and the reasons for its action as it cares to submit. Upon receipt of the complete file, it is placed in a pending file until such time as a member of the Committee notifies the secretary that he is ready to take on more cases. The earliest ones received are then assigned to him, and a cursory examination made to see if an oral hearing is desired. If it is, the secretary makes an appointment by correspondence with the appellant, suggesting that briefs of his argument upon the questions raised by the appeal be filed at least three days before the hearing. This is for the purpose of giving the member who will hear the case an opportunity for a preliminary study of the questions. The Unit is also notified,

so that the auditor whose conclusions are questioned may be present, and the Solicitor as well, if any question of law seems to be involved. After the hearing, the member carefully studies the facts which have been brought out, and the law and regulations applicable to the case, and formulates his conclusions in writing in the form of a proposed Committee Recommendation. Copies of this are furnished each of the other members, and at least once a week, or oftener, if necessary, all members meet in conference for a consideration of the opinions so prepared. In these conferences, the facts and treatment of them are fully discussed, and if the various members are satisfied that the recommendations as prepared are sound and proper, they are signed by the Chairman and forwarded to the Commissioner for his approval. If there are differences of opinion, these are threshed out until all can agree, if possible. If it is not possible to reach an unanimous opinion, the majority view prevails, and the opinion is sent back, if necessary, for rewriting in accordance with the view held by the majority.

The questions submitted to the Committee are of course very varied. Sometimes they are submitted mainly because the taxpayer is indisposed to pay the tax demanded until he has exhausted every opportunity of escape by appealing to the last authority. These are few in number, however, and ordinarily each one presents a real question. Sometimes it is a problem of correct construction of the law and regulations; sometimes as to the regulation applicable to a particular state of facts. Most frequently, perhaps, it is a question of the exercise of discretion or judgment. It must be remembered that many times large taxes hinge upon questions of fact which are not capable of positive proof, and as to which a conclusion must be reached in the light of the best evidence obtainable. Upon such questions minds will differ widely. Examples of this kind of cases are those involving valuation of assets, tangible or intangible, at the time when paid in for stock years ago, affecting invested capital, or as of March 1, 1913, when subsequently sold, involving the extent of the profit or loss when sold. Other examples, which, incidentally,

constitute a very large and difficult class, are those arising from the disallowance of a part of the salaries of officers claimed. The Treasury seldom, if ever, questions salaries paid as the result of open bargaining between the company and the officer, if the latter is not a stockholder, and the question most frequently comes up when the officers own a controlling interest and are able to vote themselves such salaries as they see fit. Prior to 1916, the tax on corporations was at the same rate as the normal tax on individuals, and the salary claimed made no difference. If the corporation claimed a deduction for salary paid the recipient paid normal and surtax on it. If profits were distributed as dividends, and not in the guise of salaries, the corporation paid tax and the recipient paid no normal tax on the amount. The Government received the same amount in either case. With the coming of the excess profits tax, however, all this changed, and in many cases the advantage of distributing profits as salaries was very great, hence the necessity of a close scrutiny of salary allowances.

Possibly the most difficult cases to discuss intelligently with the taxpayer are those where assessment under the law is determined by comparison with other taxpayers in a similar line of business, because of inability to determine the taxpayer's true invested capital, or because of the existence of some of the other grounds under the law for such action. This is because the facts which are the basis for the conclusion reached cannot be disclosed to the taxpayer, for the reason that to do so might give him an insight into some other taxpayer's affairs, which the officer is forbidden by law to do. Consequently about the only specific ground for complaint that he can ordinarily present is his belief that the tax is too high, as a result of using unfair comparatives. As he does not know what comparatives were used, he is at a decided disadvantage in presenting his side of the case.

Whatever the character of the case, whether the appeal seems frivolous or well-founded, whether the amount involved is trivial or huge, the case receives the most careful scrutiny to make as sure as possible of the soundness of the principles

involved. Precedents are fearsome things in the administration of the law, and the decision of a case upon an unsound basis of principle may set up a precedent which it will be very awkward to ignore later.

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